The International Economy

THE INTERNATIONAL ECONOMY

Walter Krause, Ph.D.

HOUGHTON MIFFLIN COMPANY *Boston*
New York • Chicago • Dallas • Atlanta • San Francisco
The Riverside Press Cambridge

The Riverside Press
CAMBRIDGE, MASSACHUSETTS
PRINTED IN THE U.S.A.

Preface

This book is intended for use primarily by undergraduate students. The only prior preparation in economics required of the student is a familiarity with the material generally covered in a course in elementary economics.

The emphasis of the book is directed toward "problems" and "policies." Theoretical and historical materials are of necessity also included, but these are subordinated to, or oriented toward, problems and policies.

An explanation may be in order as to why I chose to emphasize problems and policies, rather than theoretical analysis or historical exposition. In most schools the great majority of students who enroll in an introductory course in international economics have no intention of becoming professional economists; indeed, many of the students major in fields other than economics, e.g., political science, journalism, and business administration . The instructor, of course, is assigned a difficult task in having to decide what is "best" for a group of students with diverse interests, especially when few of these students will be exposed to additional formal work in the field. My conclusion, formed on the basis of my own teaching experience at Dartmouth College and the Universities of Texas and Utah, is that the subject matter under the circumstances might well be directed toward helping the individual student to become acquainted with the major problems which actually beset the world and with the potentialities and limitations of particular policies which might be pursued in consequence of these problems. The occasional student who chooses to continue in the field is not thereby precluded from becoming a technician; at the same time, those students for whom the introductory course is also the terminal course will have gotten something relatively "tangible" which they can then carry over directly into their daily lives without further ado.

The book is designed for use in a one-semester course in which there is little or no outside reading, or a full-year course in which the various topics are supplemented with outside reading. Lists of selected readings are included at the ends of chapters.

A number of acknowledgments are due. First, I want to take this opportunity to indicate my long-standing indebtedness to Professors Gottfried Haberler and Seymour E. Harris of Harvard University, under whom I once was privileged to study international economics. Second, I am grateful to Professor Wilson E. Schmidt of The George Washington University and Professor Jack N. Behrman of Washington and Lee University, each of whom read portions of the manuscript at various stages of its development, and to Mr. Robert E. Pierson, graduate student at Northwestern University, who assisted in the research. Their comments, suggestions, and other contributions were of great help. I alone, of course, am responsible for any shortcomings or errors of commission or omission. I should add that the manuscript was substantially completed before I assumed my present position as Economist with the Council for Technological Advancement; it follows, therefore, that the ideas expressed are not necessarily those of the Council.

WALTER KRAUSE

Evanston, Illinois
September, 1954

Contents

Part IV
Trade, Investment, and Currency Problems

Part V
Policy Determination

Tables

Figures

Part I

Introduction

All countries today participate in international commerce, some to a greater extent than others. Part I is devoted to an examination of why countries engage in international trade, and to an evaluation of the importance of such trade for the participating countries.

1

The Basis of International Trade

TRADE, the interchange of goods and services, may be carried on within the confines of a single community, between different parts of the same country, or between different countries. Few of us would dispute the economic merit of the exchange of goods and services between individuals within a single community. As individuals we dislike doing all tasks for ourselves. We generally prefer to labor in our respective lines of endeavor in the hope of acquiring sufficient means to enable us to purchase those goods and services which we desire but do not ourselves produce. Some tasks may prove entirely beyond our ability, e.g., the construction of a house or of an automobile, yet we desire the end products. In other instances we find that tasks we are able to perform may nevertheless be left to others, either because others are able to perform them better, or because we are able to utilize our time and energy more advantageously in another connection. In short, as individuals we prefer to specialize rather than to be "jacks-of-all-trades." This personal specialization is economically justified because it tends to yield benefits which are reflected in a higher standard of living, individually and collectively.

Nor would we be inclined to dispute the economic merit of trade between persons located in different sections of a single country. As we gaze at a typical menu, we do not think it unusual that the items should have originated in far separated localities — citrus fruits from Florida,

steak from Texas, potatoes from Maine or Idaho, vegetables from California, bread made from Kansas wheat, etc. Nor do we think it unusual that our automobile should be manufactured in Michigan of steel processed in Indiana from iron ore mined in Minnesota, and that it should be powered with Texas petroleum which in turn may have been refined in New Jersey. Such cases are found to be numerous when we examine the simple items which comprise an integral part of our daily lives. In our economy we long ago became accustomed to such a pooling of resources and effort, and we have come to recognize that a higher standard of living is possible when each state or locality specializes in some line or lines in which it is relatively proficient and then exchanges its surplus output for that of others.

But when we come to the *international* exchange of goods and services, many persons appear to be far less certain of the economic merit of the process. For some persons, perhaps many more than we would like to assume, the word "international" raises doubts, if not outright opposition. The fact remains, however, that trade between countries differs only in degree from trade between different sections of the same country or from trade within the confines of a single community. As we shall see, the economic reason, or justification, for international trade is similar to that for trade within a single country or community. Very simply, international trade offers a way to raise the standard of living within the participating countries.

Two closely related factors figure importantly in an explanation of why international trade serves to raise the standard of living. First, not every country is equally well equipped to produce every type of product or service. The plain fact is that the world is a very diverse place in many respects. Some countries are inherently richer on the basis of what they have to work with than are others; in addition, the various countries tend to be relatively rich and poor in different things. Second, because of the foregoing environmental differences between countries, the "costs" involved in producing various types of products or services differ widely from country to country. It is precisely because there are differences in costs of production between the various countries that trade occurs between them. The crucial point is that some goods and services may be obtained more cheaply through the indirect means of trade than through the direct means of production at home. The practice of trade, since it in essence allows the various countries to pool their strong and weak points, makes it possible for each country to devote more of its effort to the type of output in which its costs are relatively low, and to avoid having to devote as much of its effort to the type of output in which its costs are relatively high. The end result is to give the world's population a given array of goods and services

at a lower total cost than otherwise possible. This, very briefly, is how international trade may serve to raise the standard of living.

We may, however, examine this fundamental question in greater detail. The ensuing pages, accordingly, are devoted, first, to a survey of some of the differences in national environments and, second, to a discussion of the manner in which these differences give rise to cost differentials (and trade) between countries.

DIFFERENCES IN ENVIRONMENT

Countries vary in their abilities to produce the goods and services which help satisfy the wants of people. The greater or lesser ability of individual countries to produce along particular lines depends, basically, upon the particular *combinations of the factors of production* — natural resources, labor, and capital — with which they are endowed,[1] as well as upon some additional factors. We may cite a few of the more important environmental factors which help determine the nature of economic activity within particular countries.

1. **Climate and Natural Resources.** Climatic conditions and rainfall vary greatly between different parts of the world. The variations we meet as we move from tropical areas through temperate zones and on into polar latitudes are in turn reflected in a wide range of productive activities. We observe this particularly in the case of agricultural production, but it is also important in some other lines of economic activity. For example, the production of bananas and coffee is associated with a tropical climate, whereas the production of wheat is pretty much restricted to the temperate zone. Similarly, certain types of commercial fishing are confined to the oceans in colder latitudes, while others are restricted to tropical waters.

In similar fashion, the pattern of natural resources tends to condition the nature of economic activity. Some parts of the world are abundantly endowed with mineral resources, including deposits of iron and coal and other strategic minerals, which enable them to undertake and maintain industrial production. Other parts of the world lack mineral resources but may have abundant and fertile land resources, or extensive stands of timber, and are therefore better suited for other types of production.

2. **Labor Supply.** The amount and character of labor has much to do with determining the type of production in which a country will engage.

[1] Management is sometimes listed as a fourth factor of production. Some economists, however, simply treat it as a special category of "labor" and classify it accordingly. The latter is the treatment used in this book.

In the Orient, labor (common labor) is abundant and cheap relative to other factors of production, while in the United States the opposite situation prevails, labor being relatively scarce and expensive. Similarly, labor in underdeveloped countries frequently is almost entirely unskilled and is engaged largely in low-level tasks, in contrast to the high proportion of skilled workers represented in the labor force of the typical more advanced economy. In addition, the populations of particular countries sometimes develop special aptitudes, perhaps by way of tradition, the effect of which is to give them an advantage in particular pursuits. Examples include seafaring in the case of Norway and precision tasks in the case of Switzerland. These factors and others affecting labor serve to influence the type of production which develops within particular countries.

3. Capital Equipment. Modern industrial production requires the use of much equipment and machinery. The more advanced countries of the world are relatively rich in capital and hence are able to develop and maintain industrial processes of various types, whereas the underdeveloped countries typically suffer from a deficit of capital, as a result of which they find it impossible, or at least extremely difficult, to initiate industries of even modest proportions.

4. Proximity to Markets. Countries which possess all other requisites sometimes fail to qualify as producers of a particular type of output simply because they are located too far from the population centers which might comprise their market. Transportation costs may in their case effectively rule out a particular type of production which they are otherwise fitted to undertake. There is a tendency in international trade, just as in the case of trade within a country, for producers located far distant from markets to concern themselves with marketable products which prove relatively easy or inexpensive to transport, and to leave the production of bulky and hard-to-transport products to producers located nearer the ultimate markets.

DIFFERENCES IN COST

Differences in endowment or aptitude thus are important factors in determining the types of economic activity which come to prevail in the various countries. Because of the wide differences between countries, there tends to be a physical basis for trade between them. This physical basis, however, leads to actual trade only because the differences in endowment or aptitude give rise to differences in costs. Fundamentally, *international trade occurs because of international differences in costs.*

Although cost differentials also prevail within the confines of a single

country, they tend, in general, to disappear or at least to diminish since the factors of production are theoretically free to move about. In the international economy, however, national boundaries constitute barriers which serve to impede the movement of the factors of production, especially of labor but also to a lesser extent of raw materials and capital. For this reason, cost differentials tend to be far more enduring between countries than within a single country.

Why should the persistence of international cost differentials motivate international trade? The basic reason is that people desire to obtain as much in the way of goods and services as they are able to on the basis of a given outlay of effort on their own part (i.e., they desire relatively low-cost goods and services, as measured by what they themselves must give up in order to get them). One way to promote this end, as recognized by Adam Smith in *The Wealth of Nations,* is through the practice of specialization.[2] Specialization, in turn, leads to an exchange of goods and services, either between people in a single community, between different parts of the same country, or between different countries. The essence of specialization is repetition — "more of the same" — and this, taken by itself, is the antithesis of variety. Since people desire a variety of purchasable goods and services as well as a relatively high volume of output, trade logically arises as a by-product of specialization. International trade is a by-product of specialization at the international level. We turn next, therefore, to an illustration of the manner in which specialization and trade between countries tend to give people a greater supply of goods and services for a given expenditure of effort.

Absolute Advantage

Let us assume a simple case involving only two countries, Country A and Country B, and two commodities, wheat and textiles. Let us also combine all productive agents under the single heading of "labor," the supply of which we may assume to be fixed. Finally, let us assume that both wheat and textiles may be produced in either country, at the costs indicated below:

	Output:		
	Wheat (bus.)		Textiles (yds.)
In Country A, 1 man-day's labor effort will produce	12	or	3
In Country B, 1 man-day's labor effort will produce	3	or	12

[2] Sixth edition, E. Cannan, ed. (London: Methuen & Co., Ltd., 1950), Chaps. I-III, esp. pp. 6-7.

We observe that A can produce wheat more cheaply than can B, but B can produce textiles more cheaply than can A. The expenditure of 1 man-day's labor effort obtains 12 bushels of wheat in A, but only 3 bushels in B; the expenditure of 1 man-day's labor effort obtains 12 yards of textiles in B, but only 3 yards in A. We may thus speak of A as having an *absolute advantage* in the production of wheat, while B has an absolute advantage in the production of textiles.

The people of each country desire both wheat and textiles, but they have a choice as to how they may go about getting these goods. Specifically, they may either practice self-sufficiency and rely entirely upon themselves, or they may specialize and trade. Which method shall they choose? Under a system of self-sufficiency, each country will devote effort to the production of wheat and textiles. Assuming, for the sake of argument, that each country divides its effort equally between the production of the two commodities, 1 man-day's labor effort in A will yield 6 bushels of wheat and 1½ yards of textiles, while 1 man-day's labor effort in B will yield 1½ bushels of wheat and 6 yards of textiles, a total production (per 2 men) between the two countries of 7½ bushels of wheat and 7½ yards of textiles. Were the countries to specialize, A might produce 12 bushels of wheat through the expenditure of 1 man-day's labor effort, while B might in the same fashion produce 12 yards of textiles, yielding a total production (per 2 men) between the two countries of 12 bushels of wheat and 12 yards of textiles, a considerably greater output for effort expended than possible under self-sufficiency.

According to the foregoing, specialization tends to increase total output. An increase in total output is of doubtful merit, however, if variety in goods (and services) is thereby sacrificed. To return to our previous example, an increase in the output of wheat and textiles may be regarded as anything but a gain if, at the same time, consumers in A end up with an abundance of wheat and little or no textiles and consumers in B end up with an abundance of textiles and little or no wheat. If a country is willing to trade, however, it may specialize and yet retain access to a variety of goods (and services). We may conclude, therefore, that specialization and trade make it possible for countries to increase output for effort expended without necessarily having to sacrifice anything in the way of variety (i.e., specialization and trade make it physically possible for countries to achieve higher standards of living). The exact extent to which each country will benefit depends upon the precise division of the gains which arise through specialization, a matter we shall subsequently treat.

Cases of absolute advantage are common in the real world. Such is a fairly typical situation in trade between countries of the tropics and coun-

tries of the temperate zone, or between industrialized and non-industrialized countries. For example, the exchange of Brazilian coffee and American wheat, or of American machinery and Central American bananas, falls into this category. The basis for specialization and trade in such cases is obvious and leaves little room for argument.

Comparative Advantage

Let us next examine cases which are less simple, but which undoubtedly predominate in the real world. What if a particular country has an absolute advantage in many lines of production, or in every line? Or, what if a particular country has no special advantage in any line? Will specialization and trade still prove beneficial in such cases? The answer is that each country will tend to gain most if it follows the rule of "putting its best foot forward." A country having an advantage in various lines tends to gain through a concentration of its effort along lines in which its advantage is relatively greatest, while a country having no clear superiority in the production of any item tends to make the most of its admittedly poor situation through the concentration of its effort along those lines in which its relative disadvantage is least.

We may illustrate this principle, again invoking our initial assumptions of two countries and two commodities, etc. Let us now assume that the following production possibilities exist:

	Output:		
	Wheat (bus.)		Textiles (yds.)
In Country A, 1 man-day's labor effort will produce	12	or	3
In Country B, 1 man-day's labor effort will produce	2	or	1

We observe that A can out-produce B in each of the two commodities (when each uses an identical quantity of labor). But while A has an absolute advantage in the production of both wheat and textiles, she has a *comparative advantage* in wheat (where she has a 12:2 advantage over B), and hence a comparative disadvantage in textiles (where she has only a 3:1 advantage over B). On the other hand, B is at an absolute disadvantage in both lines of production, but she has a comparative advantage in the production of textiles where she is at the smallest absolute disadvantage. Though A excels over B in the production of both items, the relative degrees of advantage and disadvantage continue to provide a basis for specialization and trade. The people of both countries can still benefit from trade, in this instance through an exchange of some of A's wheat for some of B's textiles. A comparison of the conditions of relative opportunity

cost (i.e., the cost of an item in terms of how much of another item must be given up in order to secure it) will illustrate why this is so.

The opportunity cost in A of 1 yard of textiles is 4 bushels of wheat (i.e., it costs A as much labor effort to produce 1 yard of textiles as it does 4 bushels of wheat), while in B the opportunity cost of 1 yard of textiles is 2 bushels of wheat (i.e., it costs B as much labor effort to produce 1 yard of textiles as it does 2 bushels of wheat). Thus, the opportunity cost of wheat is lower in A than it is in B (1 bushel of wheat costs ¼ yard of textiles in A, but costs ½ yard of textiles in B), but the opportunity cost of textiles is lower in B than it is in A (1 yard of textiles costs 2 bushels of wheat in B, but costs 4 bushels of wheat in A). When this situation prevails, both countries can gain through specialization and trade. For example, A stands to gain by trading wheat for textiles if she can obtain 1 yard of textiles for anything less than its domestic cost of 4 bushels of wheat, and this she can do since in B the cost of 1 yard of textiles may be as low as 2 bushels of wheat; B stands to gain by trading if 1 bushel of wheat can be obtained for anything under its domestic cost of ½ yard of textiles, and this again is possible since in A 1 bushel of wheat is worth only ¼ yard of textiles. On the other hand, A will offer B no more than 4 bushels of wheat for 1 yard of textiles, since 1 yard of textiles can be produced at home at the cost of 4 bushels of wheat; B will offer A no more than 1 yard of textiles for 2 bushels of wheat, since 2 bushels of wheat can be produced at home at the cost of 1 yard of textiles. The range within which trade will occur thus lies somewhere between the ratio of 4 bushels of wheat for 1 yard of textiles and the ratio of 2 bushels of wheat for 1 yard of textiles. Trade on any terms between these limits will prove beneficial to each of the two countries, since it is then possible for each to acquire some goods from abroad at a lower real cost than if the goods were produced at home.

So far we have established only the limits within which trade will prove beneficial. Whether the actual *terms of trade* (i.e., the amount of exports required to obtain a given amount of imports) will, in our example, settle near the ratio of 4:1 or the ratio of 2:1 will depend upon the relative intensities and elasticities of the demands of the two countries for one another's goods. If we assume that the terms of trade settle at 3:1 (3 bushels of wheat for 1 yard of textiles), we may readily establish the gain which will accrue to each country. The export by A of an amount of wheat which cost 1 man-day's labor effort to produce will then gain for her an amount of textile imports which would have cost 1⅓ man-day's labor effort if produced domestically (i.e., 1 yard of textiles when imported costs 3 bushels of wheat, but when produced domestically costs 4 bushels of wheat).

Similarly, the export by B of an amount of textiles which cost 1 man-day's labor effort will then gain for her an amount of wheat imports which would have cost 1½ man-day's labor effort if produced domestically (i.e., 1 yard of textiles when exported obtains 3 bushels of wheat, but an equivalent labor expenditure yields only 2 bushels of wheat if produced domestically). At any other terms of trade between the exchange ratios of 4:1 and 2:1, exchange will also provide gains for both countries, although the division of the gains will be different from those illustrated.

The principle we have illustrated is known as the *law of comparative advantage.* It states that *a country stands to gain in an economic sense if it concentrates its productive effort along those lines in which it has the greatest comparative advantage or the least comparative disadvantage, and then trades with other countries.* Thus, in our example, A stands to gain if it concentrates upon the production of wheat, in which it has the greatest comparative advantage, while B stands to gain if it concentrates upon the production of textiles, in which it is at the least comparative disadvantage.

Comparative Advantage in a Monetary Economy

In the real world, goods are not ordinarily exchanged directly for other goods. Trade usually occurs through the medium of money, and at the instigation of businessmen and traders who are interested in prices, costs, and profits, all expressed in terms of money. If our analysis is to be convincing, therefore, we must be able to demonstrate the advantages of trade in monetary terms. Let us accordingly broaden our analysis to cover comparative money costs.

Let us return to our previous arithmetical illustration, again assuming that the terms of trade have settled at 3 bushels of wheat for 1 yard of textiles. Let us assume further that both countries use the "dollar" as their monetary unit. We are now able to express the terms of trade in monetary terms: if wheat is priced at $1.00 per bushel, then textiles are worth $3.00 per yard. This in turn means that in A labor is worth $12.00 per day, since it can produce 12 bushels of wheat per day, but in B labor is worth only $3.00 per day, since the most it can produce is 1 yard of textiles per day.[3] Thus, the cost of production of wheat is $1.00 per bushel in A, but $1.50 per bushel in B (where labor costing $3.00 per day can produce only 2 bushels of wheat); the cost of production of textiles is $3.00 per yard in B, but $4.00 per yard in A (where labor costing $12.00 per day can produce only 3 yards of textiles). Assuming no transportation costs or other barriers to trade, we must conclude that money returns would be impaired if

[3] In accordance with the earlier assumption that "labor" includes all productive agents.

producers were to attempt to produce wheat in B or textiles in A. Viewed strictly from the standpoint of prices, costs, and profits, there is a basis for specialization and trade.

SOME REFINEMENTS

We may next turn to a few of the more important points which elaborate upon or refine the law of comparative advantage as previously presented.

The Mutual Interdependence Theory

The foregoing analysis, in connection with which we set forth the law of comparative advantage, embodied the "classical" theory of international trade. For well over a century this theory was accepted as offering a satisfactory explanation of why international trade occurs. During the past quarter century, however, some economists began seriously to question its completeness, if not indeed its accuracy. The major point of criticism centered on the use made of the labor theory of value (which lumps all factor costs under the general heading of "labor costs," and assumes the final costs of commodities to be proportionate to the labor hours involved in their production). Since the labor theory of value was regarded as less than completely satisfactory, it seemed only appropriate that the theory of international trade should be expressed in terms of another theory of value. This was done by Bertil Ohlin,[4] a Swedish economist, in his application of the "mutual interdependence" theory of value to the theory of international trade. The essential approach of the mutual interdependence theory is found in its emphasis upon the interdependence of supply, demand, and prices; prices are determined by the interaction of supply and demand, but supply and demand are each, in turn, affected by prices (hence, "everything depends on everything"). Although less simple than the classical theory, this theory succeeds in handling matters of the real world without resorting to as many limiting assumptions.

The mutual interdependence theory, like the classical theory, begins with the proposition that international trade occurs because of cost differences between countries. Instead of attributing such cost differences to the varying quantities of labor embodied in the commodities, however, the mutual interdependence theory frankly recognizes that the final cost of production is the combined cost which arises from the use of the various factors of production — natural resources, labor, and capital. Significantly, the factors of production appear in different combinations in the various

[4] *Interregional and International Trade* (Cambridge: Harvard University Press, 1933).

countries, and this fact gives rise to differences in costs of production (and prices). Fundamentally, therefore, the difference in commodity prices between countries is due to the relative scarcity (in terms of supply *relative* to demand) of the various factors of production within the countries. If the relative scarcity of the factors of production in, say, two countries is identical, their relative factor prices are the same, as are their relative commodity prices also, and hence there is no basis for trade between them. In the real world, however, the relative scarcity of the factors of production differs between countries. The latter fact leads to differences in factor prices and in commodity prices, thereby providing a basis for trade.

Since international trade occurs because of price differences between countries, a country tends to export those commodities which it can produce cheaply (i.e., cheaply as compared to costs in the importing country). These tend to be commodities whose production is heavily dependent upon the use of the country's relatively abundant (and hence relatively cheap) factors of production. On the other hand, the production of those commodities drawing heavily upon factors of production which are relatively scarce within a country tends to be avoided; rather, such commodities tend to be imported from a country in which their costs of production are relatively low (because of a relative abundance there of the factors of production drawn upon most heavily in the production of the particular commodities).

We may illustrate the foregoing principles, using Argentina and Belgium as examples. In Argentina, land is relatively abundant and labor and capital are relatively scarce. Land is therefore the cheap factor and labor and capital are relatively expensive. In consequence of its particular pattern of factors of production, Argentina exports commodities which result from the use of much land and relatively little labor and capital, e.g., wheat and beef. In Belgium, on the other hand, land is relatively scarce as compared to labor and capital. Land is therefore the expensive factor as compared to labor and capital. In view of its particular factor endowment, Belgium exports commodities the production of which require much labor and capital relative to land, e.g., industrial products. There thus is a basis for specialization and international trade in both Argentina and Belgium; the two countries are able to complement one another. The validity of the law of comparative advantage remains unquestioned.

Limits to Specialization

Our analysis indicates that specialization yields gains for any country willing to practice it. It is logical to ask, therefore, why a country does

not in practice specialize in that *one* activity in which its greatest comparative advantage lies, leaving other pursuits to other countries. This is a pertinent inquiry since the industry most advantageously situated presumably constitutes a formidable threat to other less advantageously situated industries, particularly since all must compete for the available factors of production. The answer is that specialization in the real world comes up against some important factors which serve to limit its application. Several of these limiting factors appear worthy of special comment.

First, countries frequently stand ready to adopt measures of various sorts, such as tariffs, designed to preclude hardship to industries which cannot effectively compete on their own. The objective of such man-made barriers to specialization and trade frequently goes far beyond merely giving assurance of survival, but may actually enable relatively inefficient industries to undergo a process of growth.

Second, specialization is limited by the extent of the market. In practice, even in the absence of man-made restrictions, specialization is limited by the transportation costs which are incurred in attempts to reach the more distant markets. At some point the cost of production of the most efficient producer plus the cost of transporting the finished products will outweigh the higher cost of production of a less efficient producer who, simply because of his proximity to a particular market, is spared similar transport outlays.

Third (although partly a further generalization of our second point), some industries tend to be subject to an element of self-limitation in their growth. An industry may have a comparative advantage up to a point, but beyond this point it may cease to have a comparative advantage. The reason is that output of a particular type within a country (or region) may be subject to increasing costs (i.e., additional output entails higher costs per unit); therefore, after a certain volume of output is reached a comparative advantage gives way to a comparative disadvantage. For example, if the world price of wheat is $2.00 per bushel, some lands in Great Britain may perhaps be profitably employed in wheat production. Such lands may be so limited, however, that the total domestic demand cannot be met from their output. To draw additional but less desirable land into wheat cultivation would require a higher price for wheat, but such a price may not be warranted in a free market since additional supplies may be obtained more cheaply from foreign countries. Such examples are common: France mines some coal, but also imports some; Cuba grows some rice, but also imports some; the United States mines some iron ore, but also imports some. The fact that a country may have a comparative advantage up to a certain volume of output, but not beyond that

volume, serves to explain why a country may meet some part of its consumption through domestic production, but may import the remainder.

Multi-country Trade

It is possible for international trade to be confined to only two countries. Thus, as in our earlier example, Country A may sell wheat to Country B, receiving "dollars" in exchange; A may then use the dollars so obtained to pay for textiles purchased in B. If total imports and total exports of the two countries are balanced vis-à-vis one another in this manner, there is said to be a *bilateral* balancing of accounts.

Another procedure, however, is more characteristic of international trade. Ordinarily numerous countries, not just two, are involved. For example, the dollar-claims acquired by Brazil from her coffee exports to the United States may be used to pay for purchases in a third country, say for machinery imported from Great Britain. Great Britain will be willing to accept the dollar-claims held by Brazil since she knows that these claims will be acceptable elsewhere. She may in fact choose to use the dollar-claims so acquired to pay for foodstuffs obtained from the United States. The United States then in effect pays for Brazilian coffee with a shipment of foodstuffs to Great Britain. The preceding situation is one of triangular trade, as distinct from bilateral trade. When numerous countries are involved, we speak of such trade as *multilateral*.

The transactions which occur under a system of multilateral trade may be compared to those which result from the writing of a personal check within our domestic economy. If Mr. A pays for goods with his personal check, the recipient of the check, Mr. B, may simply cash it at his bank. This would end the sequence of transactions based upon the particular check. On the other hand, Mr. B may endorse the check and give it to Mr. C in payment for other goods, while Mr. C may in turn endorse it and pass it on to Mr. D, etc. Not until the check is actually returned as a claim against Mr. A's bank balance do transactions related to the particular check cease to occur. Significantly, it is to be noted that Mr. C and Mr. D were paid with a claim upon Mr. A, but neither needed to engage in a direct transaction with Mr. A.

The multilateral character of international trade may be shown by dividing the world into a few broad trading regions: the tropics (tropical countries in Africa, Asia, and Latin America); the United States; regions of recent settlement (South Africa, Canada, Australia, New Zealand, Argentina, Chile, and a number of other countries); continental Europe; and the United Kingdom. An analysis of the merchandise trade of these regions in 1928, for example, reveals the following facts: the United States

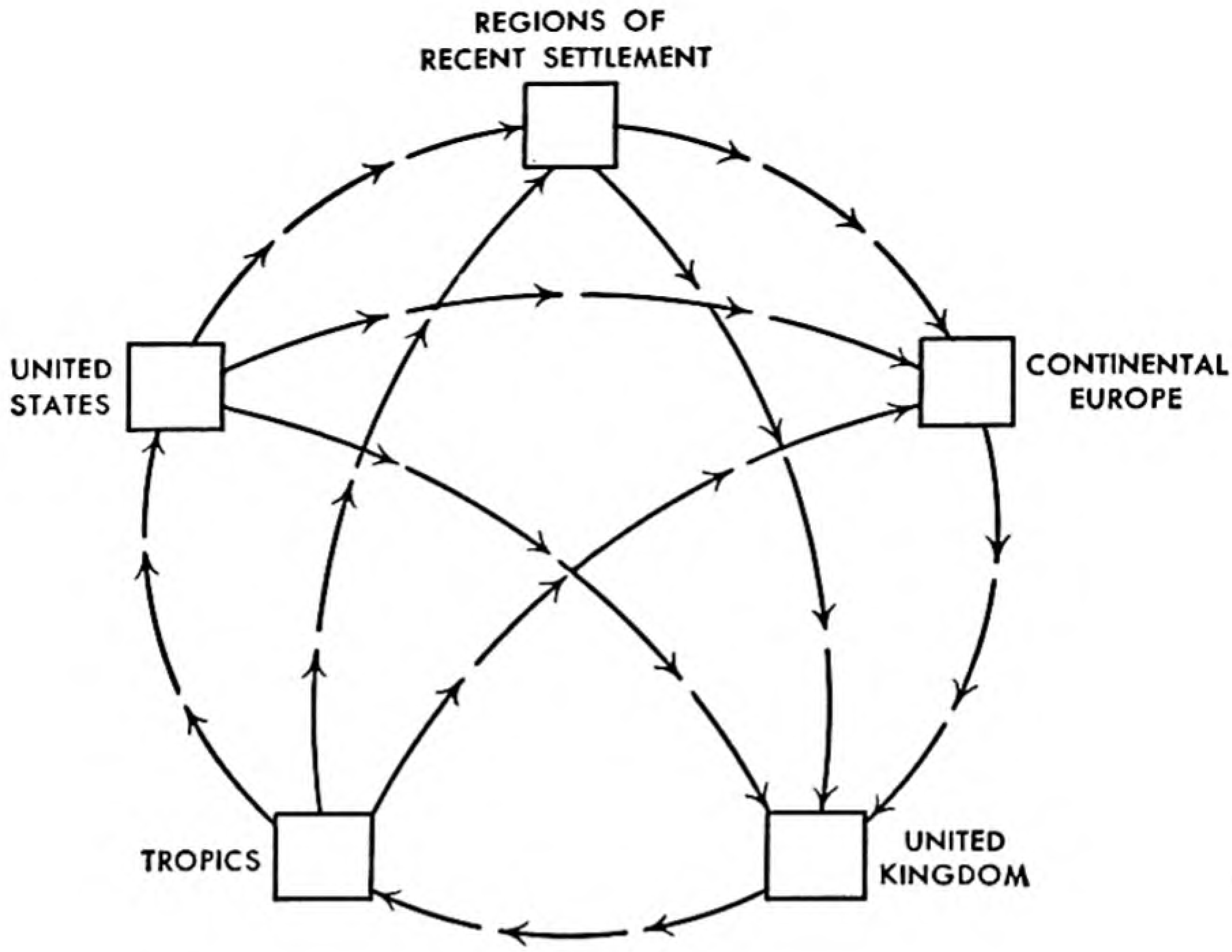


Figure 1
The System of Multilateral Trade, 1928

Source: Based on League of Nations, *The Network of World Trade,* Geneva, 1942, Diagram 6, p. 78.

had export surpluses with every region except the tropics, from which there was an import surplus; the regions of recent settlement had export surpluses with continental Europe and the United Kingdom, but had import surpluses from all other regions; the United Kingdom had an export surplus with the tropics, but had import surpluses from all other regions; and the tropics had an import surplus from the United Kingdom, but had export surpluses to all other regions.[5] These facts may be pictured by means of a diagram (Fig. 1). The direction of the arrows indicates the movement of export surpluses: arrows point from each region which had an export surplus and the arrows in each case point toward the region with which the export surplus prevailed.

The economic merit of multilateral trade is that it enables each country to acquire its imports from those foreign sources which can offer the best

[5] The total export surpluses of each region, however, did not equal its total import surpluses. Such an equality is not necessary unless international trade is restricted to merchandise trade. In reality, other transactions (e.g., services and investments), ignored by us at this stage, also enter the picture.

quality merchandise or the lowest prices, or both. In this way multilateralism tends to promote the most efficient utilization of the world's productive effort.

CONCLUSION: THE GAINS FROM TRADE

The practice of international trade makes it possible for the factors of production to be used more efficiently; in consequence, the volume of output (goods and services) which results from a given amount of productive effort tends to be greater when international trade prevails than when countries exist in a state of economic isolation. When the total volume of output is increased, the result, in turn, is a *greater real return to the factors of production* (aggregatively speaking). This is the nature of the gain to be derived from international trade.

The division of this gain between the exporting country and the importing country, however, depends upon the terms of trade which prevail. The more favorable a country's terms of trade, the greater will be its share of the total gain from trade.

SUMMARY

The fact that countries cannot produce all things equally well, or equally cheaply, provides a basis for international specialization and trade. International specialization, and the trade it gives rise to, yields benefits similar to those which arise from personal specialization or from specialization within sections of the same country, namely, greater returns per effort expended.

The essential principle which applies to international specialization is expressed in the law of comparative advantage: a country gains in an economic sense if it concentrates its productive effort along those lines in which it has the greatest comparative advantage or the least comparative disadvantage, and then trades with other countries.

SELECTED REFERENCES

There are a number of basic texts of recent date which treat many of the topics included in this volume. Some of the authors emphasize theory, others emphasize historical development, and still others present an institutional approach. A partial list of these texts is included below. The tables of contents of the texts cited may serve as a guide to the reader who is interested in checking the treatment accorded particular topics by other authors.

Brainard, H. G., *International Economics and Public Policy*. New York: Henry Holt & Company, Inc., 1954.

Ellsworth, P. T., *The International Economy*. New York: The Macmillan Company, 1950.

Enke, S., and V. Salera, *International Economics*, 2d ed. New York: Prentice-Hall Inc., 1951.

Isaacs, A., *International Trade, Tariff and Commercial Policies*. Chicago: Richard D. Irwin, Inc., 1948.

Killough, H. B. and L. W., *Economics of International Trade*, 2d ed. New York: McGraw-Hill Book Company, Inc., 1948.

Kindleberger, C. P., *International Economics*. Homewood, Ill.; Richard D. Irwin, Inc., 1953.

Marsh, D. B., *World Trade and Investment*. New York: Harcourt, Brace & Company, Inc., 1951.

Snider, D. A., *Introduction to International Economics*. Homewood, Ill.: Richard D. Irwin, Inc., 1954.

Towle, L. W., *International Trade and Commercial Policy*. New York: Harper and Brothers, 1948.

Young, J. P., *The International Economy*, 3d ed. New York: The Ronald Press Company, 1951.

The "Selected References" appended to each of the subsequent chapters will be restricted to other primary and secondary sources which may prove of interest to the reader who wishes to delve further into specific topics. Particular references, which in the opinion of this author may prove most helpful to the reader who does not have time or inclination to check into all the sources cited, are preceded by asterisks (*). References for Chapter 1 include the following:

*Condliffe, J. B., *The Commerce of Nations*. New York: W. W. Norton & Company, Inc., 1950, Chap. XXII.

*Haberler, G., *The Theory of International Trade*. New York: The Macmillan Company, 1950, Chap. IX-XII.

League of Nations, *The Network of World Trade*, Geneva, 1942.

*Ohlin, B., *Interregional and International Trade*. Cambridge: Harvard University Press, 1933, Chap. I-XII, Appendix III.

Samuelson, P. A., "The Gains from International Trade," reprinted in American Economic Association (ed.), *Readings in the Theory of International Trade*. Philadelphia: The Blakiston Company, 1949.

Zimmerman, E. W., *World Resources and Industries*. New York: Harper and Brothers, 1951.

A few organizations whose names reappear many times in footnote references will be referred to in abbreviated form as follows: UN for United Nations, IMF for International Monetary Fund, and IBRD for International Bank for Reconstruction and Development.

2

The Importance of International Trade

Having considered why international trade occurs, let us attempt to evaluate its importance. International trade, of course, is not everywhere equally important. In some countries, many or most people in the course of their daily lives come to be intimately associated in one manner or another with factors hinging upon the international economy. Americans traveling abroad are frequently astounded by the facility with which hotel personnel, taxi drivers, and merchants are able to quote foreign-exchange rates, both official and unofficial. Elsewhere, however, and especially in a large and relatively self-contained country like the United States, the domestic economy looms so large in comparison with the international economy that popular thinking comes to be oriented primarily to economic matters of a domestic nature, and relatively few people are thrust into the position of being repeatedly reminded of the importance of international trade. The average American, for example, tends to feel much less dependent upon the international economy than does his counterpart in Great Britain, Switzerland, Argentina, or in most other countries for that matter. Actually he may be less dependent, although he is still dependent in some degree. It is the extent and nature of this dependence which will concern us in this chapter.

THE IMPORTANCE OF INTERNATIONAL TRADE TO THE AMERICAN ECONOMY

The United States is one of the most nearly self-sufficient countries in the world. In part this self-sufficiency has been artificially induced through

the adoption of trade restrictions, but even in the absence of man-made barriers to trade the American economy would still be relatively self-contained. Such would be the case because within its vast area is found a resource pattern which is perhaps unequaled in any other country in abundance and diversity.[1] The United States, therefore, does not need to rely upon foreign trade to the same extent as some other smaller or less richly endowed countries. In a recent typical year, we find that American imports amounted to only 4 per cent of national income, while

Table 1

Imports and Exports as a Percentage of National Income, Selected Countries, 1952

	Imports	Exports
Netherlands	48	46
Belgium-Luxembourg	39	39
Norway	38	24
Japan	38	24
Union of South Africa	37	30
Denmark	36	27
New Zealand	35	37
Australia	33	21
Cuba [1]	32	40
Switzerland	26	23
United Kingdom [2]	26	20
Austria	25	20
Canada	23	23
Italy	18	11
Germany, Fed. Rep.	16	17
France	15	13
Turkey	15	10
Argentina [1,3]	14	9
Brazil	13	9
United States	4	5
U.S.S.R.[4]	1	1

[1] 1951.
[2] Computed on basis of Gross National Product.
[3] Computed on basis of Gross Domestic Product.
[4] 1938.

Source: Computed from data in IMF, *International Financial Statistics*, Washington, June, 1954, pp. 42-178, and UN, *Statistical Yearbook*, 1953, New York, 1953, pp. 352-367, 418-419.

[1] The resource potential of the Soviet Union also appears to be relatively great, and some writers rate it a close second to that of the United States. Published estimates vary widely, and in any event it is difficult to make a direct comparison. An important fact, however, is that the Soviet Union has been able to achieve a remarkably high degree of national self-sufficiency on the basis of her domestic resource pattern.

exports comprised 5 per cent of national income (Table 1). These percentages stand in sharp contrast to much higher percentages in almost all other leading countries. Despite the relatively low percentages in the case of the United States, it may readily be shown that this country has a vital interest in the promotion of importation and exportation.

Table 2

United States Supplies of Selected Mineral Materials

Known Economic Reserves Adequate for Well Over 25 Years		
magnesium	lime	gypsum
molybdenum	salt	borax
coal	sand	barite
phosphate	clay	feldspar
potash		
Known Economic Reserves Inadequate		
Discoveries geologically likely, though not necessarily adequate		
copper	vanadium	petroleum
lead	tungsten	natural gas
zinc	antimony	sulphur
uranium		
Beneficiation[1] progress expected		
iron	beryllium	fluorine
aluminum	thorium	graphite
titanium	oil from shale	
Synthesis progress expected		
oil from coal		
gas from coal		
Little or No Known Economic Reserves, Significant Discoveries Not Expected		
Beneficiation [1] progress expected		
manganese		
Synthesis progress expected		
industrial diamonds	quartz crystals	
sheet mica	asbestos	
Significant beneficiation [1] or synthesis not expected		
chromium	tin	platinum
nickel	cobalt	mercury

[1] Beneficiation is defined as progress in milling and smelting methods which allows ore not now economically usable to be brought into use.

Source: *Resources for Freedom,* Vol. 1, Report of the President's Materials Policy Commission, Washington, June, 1952, p. 26.

The Need for Imports

We are apt to get a faulty impression of this country's dependence upon imports when we are told that total imports constitute a mere 4 per cent of national income. The crux of the matter is that the United States does not import an *average* of 4 per cent of *every* item it uses, but it imports *all* or a *large portion* of some *particular* items. It is the latter commodities, however few or many in number, which may prove of utmost importance for the welfare of the economy.

This country's dependence upon particular imports is discernible in several respects. First, the United States is entirely lacking in a number of vital raw materials which are important to national defense, and it is only partially self-sufficient in others (Tables 2 and 3). Minerals in which the country is deficient include chromite, cobalt, nickel, and tin. Among them are ores, or alloys made from these ores, which are necessary for the manufacture of bearings, cutting tools, or machine instruments essential in defense industries.

Second, other raw materials obtained abroad are essential to the smooth operation of peacetime industries. Examples of dependence upon

Table 3

Vital Mineral Imports of the United States, 1949

Mineral	Percentage of Consumption Imported	Mineral	Percentage of Consumption Imported
Columbium concentrates	100	Mercury	75
Tantalum concentrates	100	Aluminum (refined)	65
Quartz, radio grade	100	Graphite (natural)	63
Diamonds, industrial	100	Bauxite	57
Tin	99	Lead	57
Chromite	99	Kyanite	50
Nickel	99	Copper	48
Mica, sheet and punch	95	Tungsten	42
Beryllium concentrates	92	Pig iron and scrap	35
Asbestos	92	Fluorspar	31
Manganese ore	91	Zinc	30
Platinum groups	91	Manganese (refined)	22
Antimony	89	Crude petroleum	6
Cobalt	89		

Source: National Industrial Conference Board, *Business Record* (New York: April, 1951), p. 151.

Table 4

Imports of the United States as a Percentage of New Supply, Selected Commodities, 1952

Commodity	Percentage
Minerals:	
Industrial Diamonds	100
Tin	100
Chrome Ore	99
Nickel	99
Cobalt	95
Manganese Ore	95
Asbestos	93
Tungsten	71
Bauxite	64
Foodstuffs:	
Bananas	100
Cocoa	100
Coffee	100
Crude Chicle	100
Tea	100
Sugar	48
Other:	
Copra	100
Jute Fiber and Burlap	100
Quebracho	100
Manila Fiber	100
Natural Rubber	100
Raw Silk	100
Newsprint	82
Wool	67

Source: Information supplied by U. S. Department of Commerce.

foreign supplies include industrial diamonds for cutting tools, particular metals for alloys, and asbestos for friction equipment. The importance of these products to industry is substantiated by the suggestion, made on occasion, that minimum quantities be bought up for stockpiling in order to avoid crippling shortages or sharp market fluctuations should imports be temporarily interrupted. Other imports, such as raw wool and silk, timber products, and various metal semi-manufactures, constitute materials which provide the basis for further processing within domestic industries. The importance of imports of this type, as well as of others, is shown by statistics summarized in Tables 4 and 5.

Table 5

Major Imports of the United States, 1952

Commodity	Quantity	Value (millions of dollars)
Crude materials:		
Nonferrous ores and concentrates	. . . . .	$ 482
Crude petroleum	207 million barrels	439
Crude rubber	1,803 million pounds	618
Wool, unmanufactured	376 million pounds	382
Foodstuffs:		
Coffee	2,681 million pounds	1,376
Cane sugar	7,694 million pounds	416
Fruits, edible nuts, and vegetables	. . . . .	219
Semi-manufactures:		
Nonferrous metals	. . . . .	1,029
Wood pulp	1.9 million short tons	272
Gas oil and fuel oil	137 million barrels	231
Sawmill products	2,487 million board feet	222
Finished manufactures:		
Paper and paper products (includes newsprint)	. . . . .	600
Textile manufactures	. . . . .	396
Machinery, total	. . . . .	251
All other items	. . . . .	3,814
Total imports		10,747

Source: U. S. Department of Commerce, *Foreign Commerce Weekly,* Washington, March 22, 1954, pp. 17, 19.

Third, the American standard of living owes much to imports which in many instances are not otherwise obtainable. Among the more commonplace food products which we enjoy are a number of tropical or semitropical imports, including bananas, cacao, coffee, spices, sugar, and tea. Quebracho, an especially useful import, is used in the tanning of leather. Rubber products produced from imported crude rubber serve a multitude of purposes, not least of which includes the tires upon which our automobiles roll. In short, our diet and mode of life would undergo some rather sharp changes if imports were suddenly cut off.

The Need for Exports

As in the case of imports, the export volume of the United States accounts for only a relatively small proportion of national income — 5 per

cent in 1952. Again, however, we need to recognize that this proportion represents an average and does not accurately depict the full significance of exportation for particular segments of the economy, or for the economy as a whole. Basically, we may distinguish two major reasons why a healthy export situation is of importance to the American economy.

First, exports make it possible to obtain imports. In order to obtain imports, we must provide for payment; exports give rise to such a means of payment. In an important sense, therefore, we may look upon exports as the price we must pay for the imports we want.

Second, access to foreign markets is important to many domestic producers. This is especially true in those industries in which domestic production far exceeds domestic consumption (at prevailing prices). Exportation then offers a means for disposing of "surplus" output. Production at a level greatly in excess of domestic consumption is characteristic of numerous products, both in industry and in agriculture (Tables 6 and 7). In agriculture, for example, exports in 1952 of rice, wheat, and cotton exceeded one-third of current domestic production, and exports of dried fruits, peanut oil, and leaf tobacco exceeded one-fourth of current domestic production.[2] In assessing the importance of foreign trade, the relevant figure in these instances is not 5 per cent, but 20, 30, 40 or more per cent!

Table 6

Exports of the United States as a Percentage of Production, 1952

Industry		Agriculture	
Lubricating oil	28	Rice	58
Sulphur	25	Wheat	48
Motor trucks	16	Cotton	37
Agricultural machinery	13	Dried fruits	28
Machine tools	12	Peanut oil	26
Anthracite coal	11	Leaf tobacco	25
Bituminous coal	10	Lard	22

Source: U. S. Department of Commerce, *Foreign Commerce Weekly*, Washington, June 28, 1954, pp. 1-5.

[2] As might be expected, the proportion of domestic production exported varies somewhat from year to year. A number of variables enter the picture. First, total yield shows some fluctuation. Second, exports are drawn partly from current output, and partly from accumulated stocks. Finally, there is some tendency for exports to be concentrated within particular years in consequence of orders arising under this country's foreign-aid programs. Nevertheless, the statistics indicated are not wholly unrepresentative of what ordinarily is the case.

The actual situation may perhaps be presented in more forceful fashion if translated into terms of employment. For most people jobs have meaning, even if percentages don't. Let us then, simply for the sake of argument, translate our average of 5 per cent into numbers of jobs. Assuming that the current national income of the United States stems from a labor force of 62 million, a reduction of 5 per cent in that national income will, *on an average*, involve the jobs of 3.1 million workers. Actually, testimony presented to the House Committee on Foreign Affairs in 1947 placed the number of jobs in the United States attributable to exports at a slightly higher figure, or in excess of 3.3 million! More important perhaps, the proportion of employment in particular industries dependent upon continued exportation is considerably higher, ranging from 10 to 20 per cent in a number of industries (Table 8). Again, the relevant figure is not an average of 5 per cent but a far higher figure when applied to specific industries.

Table 7

Major Exports of the United States, 1952

Commodity	Quantity	Value (millions of dollars)
Crude materials:		
Cotton, unmanufactured	4.3 million bales	$ 874
Tobacco, unmanufactured	396 million pounds	246
Coal	52.2 million short tons	495
Foodstuffs:		
Wheat, including flour	417 million bushels	942
Manufactures:		
Machinery [1]	. . . . . .	2,716
Automobiles, parts, and accessories [1]	. . . . . .	987
Chemicals and related products [1]	. . . . . .	779
Textile manufactures	. . . . . .	659
Iron and steel-mill products	4.5 million short tons	621
Petroleum products [1]	. . . . . .	494
"Special category" items	. . . . . .	2,603
All other items	. . . . . .	3,623
Total exports		15,039

[1] Excludes "special category" items, i.e., items which for reasons of national security are not reported in detailed form.

Source: U. S. Department of Commerce, *Foreign Commerce Weekly*, Washington, March 22, 1954, pp. 17-18.

Table 8

Employment in the United States Attributable to Exports, by Industries, 1947

Industry	Employment Dependent on Exports (in thousands)	Per Cent of Total Industry Employment
Iron mines, steel works, and rolling mills	131	19.7
Iron and steel products	113	10.7
Electrical machinery	105	11.5
Machinery, except electrical	246	15.7
Motor vehicles	133	13.9
Transportation equipment (except motors)	61	9.6
Other manufacturing	61	8.8
Chemicals	84	11.2
Farm production	1,000	8.0
Food and tobacco preparations	59	3.7
Rubber and manufactures	42	14.7
Leather and leather products	19	4.9
Textiles and apparel	242	9.4
Lumber, furniture, wood pulp, paper, and printing and publishing	140	5.9
Coal mining and solid fuel	94	18.5
Manufactured gas and electrical power	22	4.7
Petroleum production and refining	34	8.8
Transportation	266	9.8
Trade	295	3.5
Business and professional services	109	1.5
Total	3,364	. . .

Source: House Committee on Foreign Affairs, Hearings, *Membership and Participation by the United States in the International Trade Organization*, Washington, 1950, p. 353.

Major export industries frequently are associated with particular areas within which they comprise the leading line of economic activity. Thus, the production of machine tools, precision instruments, automobiles, and aircraft is confined to relatively few localities, but in each case the particular industry may represent the leading industry in that locality. Similarly, in many agricultural areas a single crop, such as wheat or cotton, may dominate economic life. In each instance, a high level of activity within the major industry tends to ensure the prosperity of other lines of activity within the community. For example, if the cotton growers of the Mississippi delta area are prosperous, the grocers, automobile dealers, appliance salesmen, dentists, and others who depend upon them for their livelihood also tend to prosper. Should adverse export conditions jeopardize the

prosperity of the major industry of such a specialized area, others who depend upon a purely local market also tend to suffer a loss of income. We may conclude, therefore, that because of the economic interdependence of industries the economic well-being of the major export industries becomes a matter of concern for the entire community or country.

The Problem of Surpluses

The question may be raised as to which is relatively more dependent upon an export market, American agriculture or American manufacturing. While facts contained in Tables 6, 7, and 8 would indicate that each has every reason to value healthy trading conditions, there is an important distinction to be drawn on the basis of the nature of their respective dependence upon exportation. This distinction is perhaps most apparent in the manner in which each of these two sectors of the economy adjusts to changes in total demand.

Let us first direct our attention to the position of a manufacturing industry in which, let us assume, each firm exports 30 per cent of its output when operating at full capacity. A curtailment of foreign demand for the product, say machinery, will of course entail a lower level of income and employment for the industry, provided domestic sales cannot be increased by an offsetting amount. It does not necessarily follow, however, that the failure to offset the reduction in foreign sales with an increase in domestic sales will entail long-run surplus production for the industry. If markets contract, the volume of manufacturing output may ordinarily be cut back within a relatively short period of time. This tends to be the case largely because control over production rests with a relatively small number of firms; since each firm tends to be aware of the situation which confronts the industry, measures may ordinarily be taken to adjust the scale of operations to fit the market. It is this ability to adjust output to market conditions which is all-important in the case of manufacturing. While individual firms may experience relatively long periods of excess capacity, they generally do not suffer prolonged periods of surplus production. That portion of their output which enters the export market is ordinarily produced with a definite eye upon the particular market in question. In consequence, manufacturers of the type we describe are inclined to view exportation not as an outlet for a chronic surplus of output, but rather as an opportunity for high volume production, which among other things tends to assure them of high earnings.

This situation may be contrasted with that which prevails in agriculture. Again, let us assume that 30 per cent of the total output of a particular commodity, say wheat, normally enters the export market. What,

we may ask, would be the likely effects of a sharp curtailment in wheat exports? First of all, total production of wheat would tend to remain largely unchanged, despite a reduction in exports. This would be the likely case because there are relatively many growers of wheat. Since no one producer is able to affect the market, there would be little reason to expect individual growers to take the initiative in restricting output. Past experience indicates further that there would be no successful organized action from within the industry to curtail output, nor would there be a mass movement into other fields of production. Continued production of wheat at existent levels, despite reduced exports, would entail a second consequence, namely, a sharp decline in the price of wheat. Significantly, the demand for wheat (and for agricultural products in general) is inelastic, i.e., the quantity purchased does not increase sufficiently as price decreases to maintain total receipts. Lower prices, however, would not lead to appreciably lower output, a fact the United States learned during the Great Depression of 1929-33. It is apparent, therefore, that agriculture is ill-equipped to cope with the problems arising from a decline in exports.

In short, when manufacturers are confronted with a reduction in exports, they may seek refuge in a contraction of output. Their problem then becomes one of excess capacity, rather than of excess production. In agriculture, however, a reduction in exports leaves production largely unchanged. In this case "excess" capacity continues to be used, thereby leading to excess production. The resultant surpluses may then persist and become chronic. If, under such circumstances, the consequences of a free market in agricultural products are feared, either of two basic alternatives immediately suggests itself. One alternative involves government intervention to reduce output, while the second alternative involves government purchase and storage of surplus commodities in the hope that eventual disposal in some manner may prove possible. It is significant that both schemes have been employed as instruments of agricultural policy by the United States during the past two decades.

The Overall Importance of Trade

Thus far we have implied that international trade is important to the United States because the latter *needs* to import certain commodities and *needs* to export certain other commodities. The importance of international trade, however, may be expressed in terms other than physical "need." After all, imports which we "need" might be produced domestically by synthetic means, or might simply be done without. The foregoing are alternatives to imports, but we generally don't follow such alternative courses because we believe the "cost" will be too great. Simi-

larly, we "need" to export certain commodities which we have in "excess" supply. As an alternative, however, we might pursue domestic policies designed to prevent exportable surpluses from ever arising, or we might dispose of them domestically in some fashion. Generally we don't follow such policies because, again, we believe the "cost" will be too great.

In other words, our "need" to import and export for the greater part stems from the fact that we know, or believe, that trading is preferable to not trading. Why do we regard the former course of action to be preferable? The answer goes back to the gains from trade, discussed in the previous chapter: *a higher level of real income tends to arise when international trade is carried on* than when a state of economic isolation exists. It makes good economic sense to put the law of comparative advantage on an international basis rather than to limit its practice to the regions within a single country.

THE IMPORTANCE OF INTERNATIONAL TRADE TO OTHER COUNTRIES

While international trade is important to the United States, it is of even greater importance to some other countries (Table 1). We see, for example, that imports average but 4 per cent of national income in the United States, whereas the proportion exceeds 40 per cent in the Netherlands, and is over 30 per cent in Belgium-Luxembourg, Norway, Japan, the Union of South Africa, Denmark, New Zealand, Australia, and Cuba, and over 20 per cent in Switzerland, the United Kingdom, Austria, and Canada. Viewed in such sharp contrast, the relationship of international trade to the American economy may, in a sense, be thought of in terms of a dessert after a meal, while for many economies international trade is more like the meal itself! In some countries it is truly a case, as persons within the countries have sometimes stated, of "trade or die."

THE UNITED STATES AND THE WORLD ECONOMY

Having observed the importance of international trade for the American economy, let us examine the importance which the foreign commerce of the United States holds for the world economy. In this connection, four facts concerning United States foreign trade appear particularly noteworthy. First, its volume exceeds that of any other country. Second, its composition has undergone significant changes over the years. Third, United States merchandise exports typically far exceed its merchandise imports. Fourth, the volume of its foreign trade tends to be highly un-

stable. These facts, particularly as they relate to the *size* and *instability* of its foreign commerce, are important in an analysis of the relationship which exists between the United States and other countries.

The Volume of United States Foreign Trade

An outstanding fact concerning the United States is that its population comprises only a relatively small proportion of the world's total, but this population produces a relatively large proportion of the world's goods and services. With a population of slightly over 160 million, or roughly 6 per cent of the world's people (Table 9), the United States produces a national income which at present amounts to some 50 per cent of the world's total (Table 10). The concentration of this tremendous productive capacity and output within one country represents a fact of paramount importance for evaluating the impact of the American economy upon the rest of the world.

Pictured as a proportion of national income, the foreign trade of the United States may appear relatively small. Translated into absolute amounts, however, the volume of trade appears much more impressive. After all, even a relatively small percentage of a relatively large national income will represent a very substantial volume of trade. Thus, United States imports may average only 4 per cent of national income, but in dollar volume this represents an amount greater than the entire national income of countries such as Australia or Belgium. In fact, the volume of

Table 9

Population of the World, 1949

Region	Population (in millions)	Percentage of World Total
Africa	198	8
North America	213	9
South America	108	4
Asia (excl. U.S.S.R.)	1,254	53
Europe (excl. U.S.S.R.)	393	17
U.S.S.R.[1]	193	8
Oceania	12	1
World	2,370[2]	100

[1] 1946.

[2] Because of rounding, the sum of the continental populations does not equal the world total.

Source: UN, *National Income and its Distribution in Under-Developed Countries*, New York, 1951, p. 3.

Table 10

National Income, Selected Countries, 1949

Country	Amount (billions of U.S. dollars)	Country	Amount (billions of U.S. dollars)
United States	217	Poland	7
U.S.S.R.	60	Argentina	6
United Kingdom	39	Brazil	6
France	20	Sweden	5
India	20	Australia	5
Germany (Western)	15	Belgium	5
China	12	Netherlands	5
Canada	12	Czechoslovakia	5
Italy	11	Switzerland	4
Japan	8	Pakistan	4

Source: UN, *National and Per Capita Incomes, Seventy Countries, 1949,* New York, 1950, Table 1, pp. 14-16.

Table 11

Value of Exports, Leading Countries, Selected Years
(millions of U. S. dollars; valued f.o.b.)

Country	1938	1948	1953
World	20,868	54,144	74,778
United States	3,102	12,666	15,773
United Kingdom	2,601	6,633	7,524
Canada	918	3,352	4,616
Germany, Fed. Rep.	...	...	4,389
France	881	2,011	3,788
Belgium-Luxembourg	733	1,690	2,251
Netherlands	594	1,025	2,152
Australia	552	1,656	1,980
India and Pakistan	621	1,944	1,555
Brazil	289	1,173	1,488
Italy	553	1,077	1,488
Sweden	464	1,107	1,477
Japan	767	258	1,275
Switzerland	302	799	1,204
Argentina	408	1,626	1,135
Union of South Africa	161	565	962
China	170	104	...
Czechoslovakia	295 [1]	753	...
U.S.S.R.	251	...	...

[1] Jan.-Sept.

Source: IMF, *International Financial Statistics,* Washington, June, 1954, pp. 22, 24; data for China, Czechoslovakia, and U.S.S.R. are from UN, *Statistical Yearbook, 1953,* New York, 1953, pp. 368-375.

Table 12

Value of Imports, Leading Countries, Selected Years[1]
(millions of U. S. dollars; valued c.i.f.)

Country	1938	1948	1953
World	23,566	59,995	76,143
United States	2,465	8,058	11,837
United Kingdom	4,449	8,374	9,366
Canada	794	3,024	4,842
France	1,324	3,443	4,007
Germany, Fed. Rep.	. . .	. . .	3,771
Belgium-Luxembourg	765	2,046	2,405
Italy	593	1,539	2,395
Netherlands	803	1,872	2,382
Japan	759	684	2,410
Sweden	525	1,377	1,579
India and Pakistan	575	1,921	1,540
Australia	571	1,415	1,487
Union of South Africa	503	1,567	1,310
Brazil	295	1,134	1,299
Switzerland	366	1,163	1,179
Argentina	440	1,471	825
China	187	140 [2]	. . .
Czechoslovakia	239 [3]	757	. . .
U.S.S.R.	268	. . .	. . .

[1] Theoretically the value of total world exports should equal the value of total world imports. The differences shown between the world totals in Tables 11 and 12 are due to differences in valuation, exports being valued f.o.b. and imports c.i.f.

[2] Jan.-Oct.

[3] Jan.-Sept.

Source: IMF, *International Financial Statistics*, Washington, June, 1954, pp. 23, 25; data for China, Czechoslovakia, and U.S.S.R. are from UN, *Statistical Yearbook, 1953*, New York, 1953, pp. 368-375.

foreign trade of the United States at present exceeds that carried on by any other country (Tables 11 and 12).[3]

The Changing Character of United States Foreign Trade

As the United States has developed, its foreign trade has undergone changes in composition (Table 13). A century ago, when the country was relatively underdeveloped, imports consisted mainly of manufactures and semi-manufactures, few raw materials being imported. Exports consisted largely of raw materials, as few finished goods were available for

[3] The value of United States imports has exceeded that of British imports only since 1950, but the exports of the United States have long exceeded those of any other country.

export. The opposite situation exists today. Imports now consist largely of raw materials, along with some semi-manufactures, but there is only slight dependence upon finished imports. On the other hand, present-day exports consist mostly of finished goods.

The changed composition of foreign trade occurred basically as the result of the development of the United States relative to other economies. The significance for other countries of this shift rests fundamentally upon the adjustments which prove necessary if they are to sell their products in the United States market, which for them (collectively) represents the largest single export outlet.

The Merchandise Export Surplus of the United States

Aggregatively, the United States sells more merchandise than it buys, commodity exports having exceeded like imports in each and every year since 1900 (Fig. 2). There are, of course, reasons for this merchandise export surplus, among them being the relative abundance of goods in the United States, the relatively great foreign demand for American goods, the willingness of the United States on occasion to underwrite its

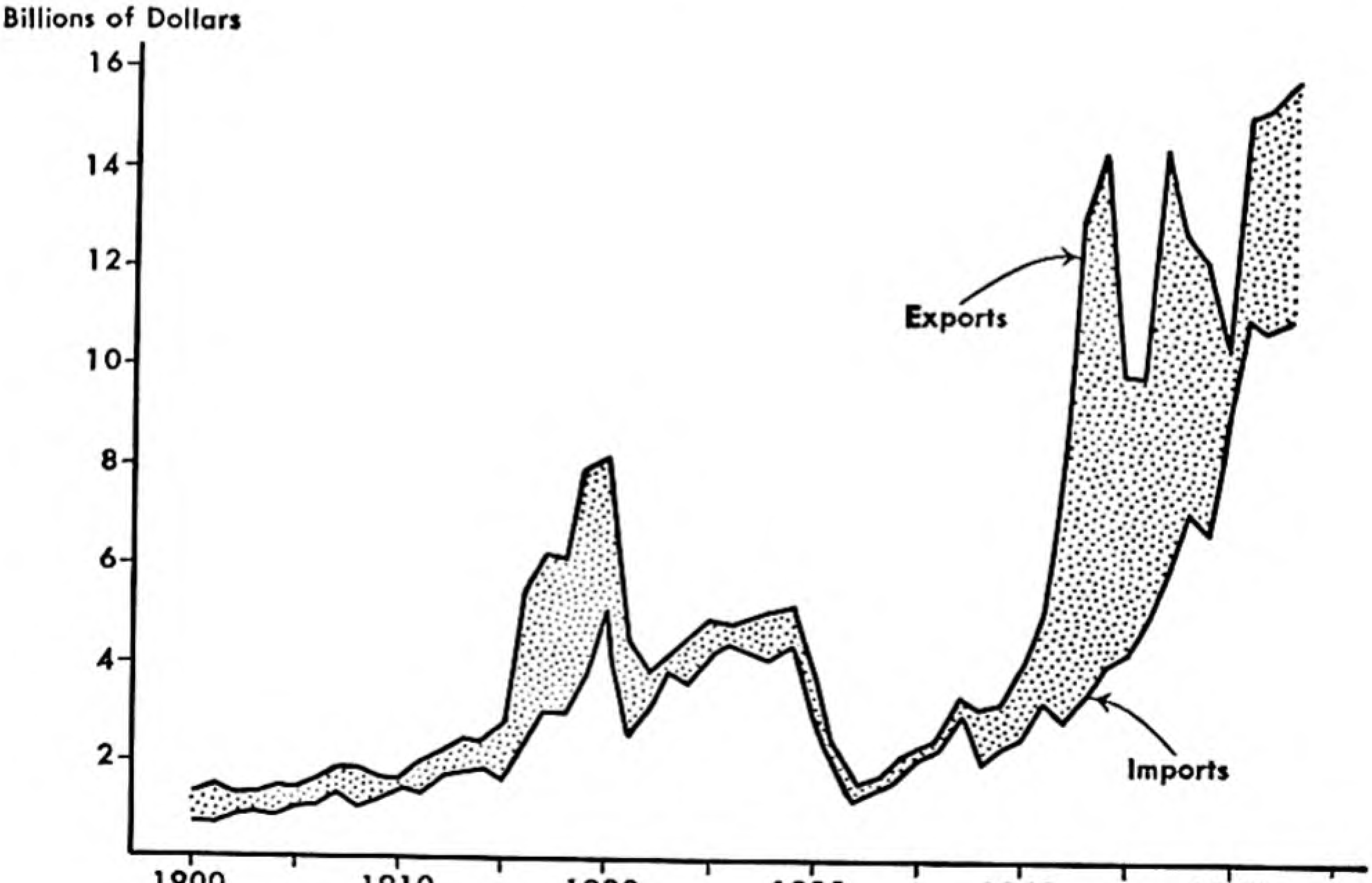


Figure 2

The Merchandise Export Surplus of the United States, 1900-1953

Source: Data from U. S. Department of Commerce, *Statistical Abstract of the United States, 1953*, Washington, 1953, p. 900, and U. S. Department of Commerce, *Foreign Commerce Weekly*, Washington, March 22, 1954, p. 17.

Table 13

United States Imports and Exports by Economic Classes, Selected Periods, 1851-1953 (in percentages)

Years	Imports			Exports		
	Raw Materials	Semi-Manufactures	Finished Goods	Raw Materials	Semi-Manufactures	Finished Goods
1851-1860	21	13	66	68	4	28
1901-1910	46	17	37	41	13	46
1946-1953	49	23	28	23	11	66

Source: Computed from data in U. S. Department of Commerce, *Statistical Abstract of the United States, 1953*, Washington, 1953, p. 904, and U. S. Department of Commerce, *Foreign Commerce Weekly*, Washington, March 22, 1954, p. 17.

exports by means of loans and grants made available to foreigners, and the reluctance of Americans to allow the entry of competitive imports.

A surplus of merchandise exports is not unique; some other countries too have such surpluses (although of much smaller size), e.g., most countries in Latin America. Nor need such a surplus constitute a problem; after all, there is no particular reason why commodity imports must equal commodity exports.[4] The existence of such a surplus in the United States is of significance to other countries mainly because of the pattern of international transactions which then comes to be required of them. If countries (collectively) other than the United States purchase more goods from than they sell to the United States, they must offset the difference with "earnings" acquired in other fashion. Briefly, such earnings can arise only from the sale of services and gold (in excess of like purchases), or from the receipt (net) of loans and grants.[5] It is the latter device — loans and grants — which has been largely responsible for sustaining the merchandise export surplus of the United States, at least during very recent decades.

The Instability of United States Foreign Trade

The foreign trade of the United States tends to be highly unstable, much more so than that of many other countries. This instability is directly attributable to fluctuations which arise in the domestic economy and

[4] Unless foreign trade consists entirely of commodity trade.

[5] Dollar earnings accumulated during earlier periods may also be drawn upon, but such withdrawals are of necessity limited in amount and duration.

which, in turn, serve to influence the volume of imports and of new foreign investments (and hence the extent of economic stability abroad).[6]

When the United States economy is booming, the demand for imports tends to reach relatively high levels. Industry then stands in need of a substantial volume of raw-material imports, and the consumer demand for foreign commodities also reaches considerable proportions. As the volume of importation increases, foreigners acquire the means to finance additional purchases from abroad. The end result is that a high volume of importation is accompanied by a high volume of exportation. When a recession or depression strikes the American economy, however, this country's demand for imports tends to decline sharply. The inability of foreigners to export their goods at previous levels leads to a slowing down in economic activity abroad and, in turn, to a reduced volume of importation by the countries concerned. This is the economic basis for maintaining that *a depression arising in the United States tends to be transmitted to foreign countries via a contraction of trade.*

Fluctuations in the rate at which new foreign investments are undertaken also serve to create instability in American foreign trade. When the United States economy is booming, foreign economies also tend to experience prosperity. This atmosphere of mutual prosperity is conducive to the undertaking of new investments, both at home and abroad, by United States investors. The foreign investments serve to sustain an additional flow of exports as the funds exported return, sooner or later, in payment for goods and services. (The investment funds return to the country of origin just as a personal check eventually returns to the bank against which it is drawn.) When depression strikes, however, the resultant financial plight at home and abroad is not likely to inspire potential investors. The near cessation of new foreign investments is, in turn, accompanied by a contraction of exports. Thus, fluctuations in the rate at which new foreign investments are undertaken create instability in the flow of exports from the United States.

In short, the ability of the United States to export rests upon its will-

[6] In discussing the instability of the American economy, and the consequent repercussions upon the world economy, a UN report stated that "in the future the real danger to the economic stability of the rest of the world lies in recessions originating in the United States: partly because of the dominant position of the United States in international trade and payments, and partly because of the institutional and economic factors which make the United States economy more liable to internal fluctuations in effective demand than are the economies of other important trading nations. . . . The main point is that a workable international economic system must in any case provide an insurance against fluctuations in the United States. If it can successfully cope with these then only a relatively small margin need be allowed for the risk of independent fluctuations elsewhere." See UN, *Measures for International Economic Stability,* New York, November, 1951, Annex, p. 42.

ingness to import and to launch new foreign investments. When a depression strikes the domestic economy, the reduction in importation and in new foreign lending leads to a shrinkage in exports because foreigners come into possession of less dollars with which to pay for such exports and because foreign demand decreases as national income is reduced in the countries concerned. A classic illustration of such a shrinkage in export volume is found in the experience of the United States during the period of the Great Depression. The depressive effects upon the domestic economy were so intense that the supply of dollars made available to foreigners with which they could buy this country's goods and services declined by 68 per cent between 1929 and 1932 (Table 14). The contraction dealt a staggering blow to those economies which had come to rely heavily upon sales in the American market or upon the receipt of American investment capital. The impact was also felt in a serious curtailment of United States exports. Allowing for amounts needed by foreigners to service foreign-held obligations, the volume of dollars held by the rest of the world which could be used to purchase goods and services in the United States (or acquire United States investments) declined by 77 per cent!

Because of economic interdependence among countries, the adverse effects of a major depression, should one arise in a leading trading country, are not readily restricted to one or a few countries. Rather, the effects tend to be transmitted from country to country and tend eventually to become world-wide. For example, if the level of economic activity declines in the United States, its imports from Countries A, B, C, and D are reduced. Each of the latter in turn buys less, not only from the United States, but also from the other countries. In consequence, each of the

Table 14

Decline in the Supply of Dollars Available
to Foreign Countries, 1929-1932
(millions of dollars)

Dollars	1929	1932	Amount of Decrease	Percentage Decrease
Dollars supplied by the U. S. through purchases of goods and services and new investments abroad	7,400	2,400	5,000	68
Dollars required to meet fixed-debt-service payments to the U. S.	900	900	0	0
Remainder available to foreign countries for the purchase of U. S. goods and services or for investment in the U. S.	6,500	1,500	5,000	77

Source: U. S. Department of Commerce, *The United States in the World Economy*, Washington, 1943, p. 6.

countries tends to suffer a loss of economic activity, leading to a further curtailment of imports, etc. The overall effect is a cumulative contraction of world trade. The precise nature of this process of contraction during the years of the Great Depression is graphically illustrated in Fig. 3. Reading clockwise, we observe that the value of world trade in each month during the period of contraction was less than in the same month of the year preceding.

In summary, because the United States is an "economic giant," a unique relationship tends to exist between it and other economies. For example, imports from a given country may constitute less than 1 per cent of the national income of the United States, but this amount may comprise, perhaps, 10, 15, or 20 per cent of the exporting country's national income.

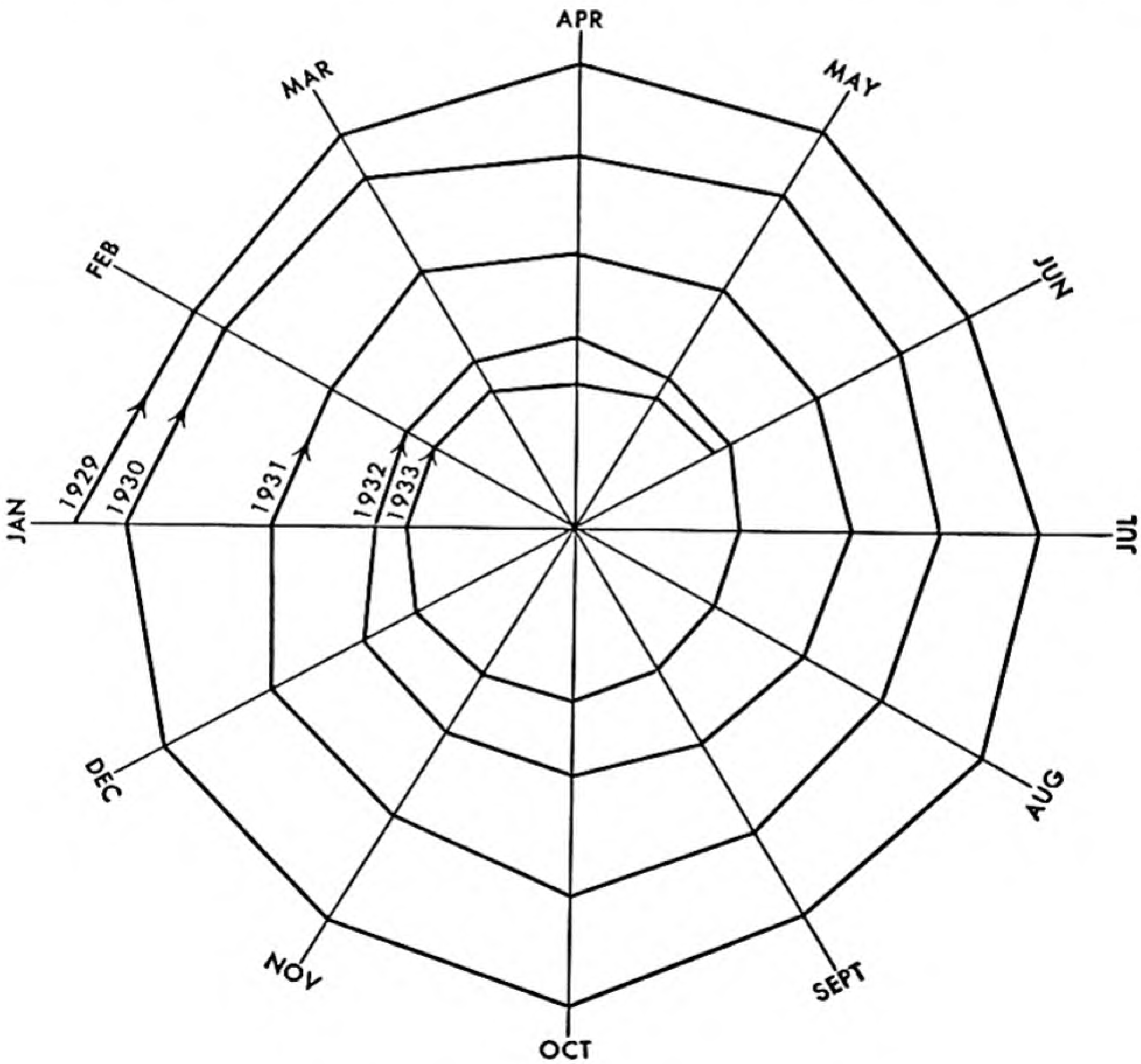


Figure 3

The Contracting Spiral of World Trade, 1929-1933

Source: Adapted from League of Nations, *World Economic Survey, 1932-3*, Geneva, 1933, p. 8.

It follows, therefore, that because of the relatively great size of the American economy in comparison with other economies the fluctuations in the foreign trade of the United States tend to hold more meaning for foreign countries than do similar fluctuations abroad for this country. In short, what happens in the foreign commerce of Honduras, Paraguay, Belgium, or any single foreign country tends generally not to be of insurmountable importance for the United States; but, in contrast, major developments in the foreign commerce of the United States tend to be quite important for the typical foreign country. This is the basis for maintaining that *the first prerequisite for prosperity in the world is a prosperous United States.*

SUMMARY

International trade tends to be of less relative importance to the American economy than it is to many other economies. Nevertheless, the United States is entirely or partially dependent upon particular imports which are vital for national defense and the smooth operation of the economy. Similarly, the prosperity of the country is dependent upon an export market for some of its products. This is especially true in particular industries, e.g., in the production and exportation of cotton, wheat, rice, tobacco, and other products.

While the United States may not be as dependent upon international trade as are some other countries, the world economy as a whole is quite dependent upon the American economy. Two major factors are responsible for this situation. First, the volume of United States trade, in absolute amounts, is greater than that of any other single country. Second, United States trade has shown a tendency to fluctuate widely. These fluctuations in American foreign trade, while perhaps not of overwhelming importance to the domestic economy, tend to produce major economic repercussions abroad, especially for those countries which are heavily dependent upon the American market as an outlet for their specialized output.

SELECTED REFERENCES

°Buchanan, N. S., and F. A. Lutz, *Rebuilding the World Economy.* New York: The Twentieth Century Fund, 1947.

Condliffe, J. B., *The Commerce of Nations.* New York: W. W. Norton & Company, Inc., 1950, Chap. X.

°League of Nations, *Industrialization and Foreign Trade,* Geneva, 1945.

————, *The Network of World Trade,* Geneva, 1942.

Van Royen, W., and O. Bowles, *The Mineral Resources of the World.* New York: Prentice-Hall, Inc., 1952.

Part II

International Payments

In Part I we learned why international trade occurs, and why it is of importance to countries. Part II treats the special payments aspects of international trade. The material in this section is largely theoretical, and in some respects is far from simple. An understanding of the material, however, is helpful, indeed essential, if we are to grapple successfully with the practical problems which arise in the field.

3

The Balance of Payments

INTERNATIONAL TRADE is a two-way affair. Its reciprocal nature was quite apparent in earlier times when transactions consisted very largely of exports and imports of physical merchandise and when actual barter was fairly common. Today, in contrast, the reciprocal nature of a country's dealings tends to be obscured by the presence of a relatively large volume of "invisible" transactions, such as those of a service and investment character, as well as by the presence of an intricate financial structure for handling foreign transactions. The reciprocal nature of foreign trade needs to be borne in mind, however, and may be more fully comprehended through an examination of a country's balance of payments.

THE MEANING OF A BALANCE OF PAYMENTS

The *balance of payments* of a country is a systematic record of all economic transactions [1] completed between its residents and residents of the rest of the world during a given period of time, usually a year. In such a record each of the many transactions which occur across a country's frontiers may be grouped, along with other similar transactions, under one

[1] Some relatively few transactions escape detection, e.g., contraband, articles transported on one's person and not declared, etc. Such transactions are either omitted or are assigned arbitrary values (rough estimates).

or another of a few major classifications. The balance of payments thus provides a record which reveals such facts as the country's total payments for merchandise and services purchased abroad, the total receipts from foreign sales of merchandise and services, the total amounts loaned and borrowed, etc. By studying such a record we may come to a better understanding of a country's overall economic position. For example, the magnitudes of the various classifications of transactions reveal how a country "pays its way" internationally. Similarly, the interrelation of the major classifications of transactions may reveal important facts concerning a country's role within the context of the world economy.

COMPOSITION OF THE BALANCE OF PAYMENTS

All transactions between the residents of a given country and the residents of the rest of the world give rise to either claims or counterclaims for payment. An export of merchandise, for example, gives the exporter a claim for payment upon the foreign importer. An import of merchandise, on the other hand, obligates the importer to the foreign seller. All transactions by residents of a country which add to that country's payments-claims represent "credit" transactions in its balance of payments (i.e., the transactions serve to make the country more of a creditor, or less of a debtor). Those transactions by residents of a country, in contrast, which create payments-obligations comprise "debit" transactions (i.e., the transactions serve to make the country more of a debtor, or less of a creditor).

Double-Entry Procedure

We may conclude from the above that *international transactions undertaken by residents of a country may be classified as credits or debits simply by determining whether they give rise to payments-claims upon, or payments-obligations to, residents of foreign countries.* It may be noted that a credit transaction in one country's balance of payments automatically becomes a debit transaction in the balance of payments of another country, and vice versa. As we shall also see, every transaction has both a debit and a credit side in each country's balance of payments.

The Meaning of "Resident"

The balance of payments of a country then summarizes all debit and credit transactions between its residents and the residents of all other countries. But what is a resident? For balance-of-payments purposes, the term covers private persons, commercial firms, and governments. Thus, the balance of payments of a country summarizes the various transactions

which occur across its frontiers, whether these are undertaken by individuals, by business concerns, or by the government, and whether undertaken with a foreign person, business concern, or government.

In general, *persons* actually residing within a country are regarded as its residents. For example, an American living within the United States is clearly a resident of this country, but so also is a Canadian who lives within the United States for an extended period of time and earns his livelihood here. An American traveling abroad continues to be regarded for purposes of the balance of payments as a resident of the United States, while a Canadian touring the United States continues to be regarded as a resident of Canada.

As for *commercial firms,* home-owned corporations with plants located only within the home country are clearly residents of the country in question. When such a corporation opens a branch plant abroad, however, the branch plant is treated in the balance of payments as a resident of the foreign country.

Government transactions are treated in the balance of payments in a manner similar to that accorded the transactions of private persons.

Transactions

International transactions may be grouped into a few broad categories. We may examine these categories, viewing individual transactions from the standpoint of the United States. (For purposes of its balance of payments, the value involved in a country's transactions is expressed in terms of national currency, e.g., dollars in the balance of payments of the United States, even though particular transactions may specify payment in some other currency unit.)

1. **Merchandise.** The merchandise category has always been the largest single item in the balance of payments of the United States (and in virtually all other countries also). As we have already observed, exports of goods from the United States give this country a payments-claim upon foreigners, and the value of the goods is therefore listed on the credit side of the balance of payments. Imports represent a payments-obligation for this country and are therefore entered as a debit.

2. **Services.** The United States renders many forms of service to residents of foreign countries, the sale of which gives this country a payments-claim upon foreigners. Among these services are shipping services rendered by American firms in transporting foreign passengers and freight, the sale of transportation, food, and lodging to foreign tourists visiting this country, insurance premiums and brokerage fees paid to American firms

by foreign individuals or firms, etc. Since each of these transactions gives the United States a claim for payment, each is entered as a credit item for this country. On the other hand, foreign countries receive a claim upon the United States when foreign ships transport residents of the United States or goods owned by them, when foreign insurance or brokerage firms render services to Americans, when American tourists make purchases abroad, etc. Because each of these transactions represents a foreign payments-claim upon the United States, each is entered as a debit item for this country.[2]

3. **Interest and Dividends.** American investments abroad, whether in foreign branch plants, in the securities of foreign governments or private foreign corporations, in bank accounts, or in personal loans, yield a return in the form of interest or dividends. Interest and dividends so earned comprise a payments-claim, and accordingly are shown as a credit in the balance of payments of the United States. On the other hand, interest and dividends owed by the government, corporations, banks, or private individuals of the United States to residents of foreign countries by virtue of their investments in this country give foreigners a payments-claim upon the American economy, representing a debit in the balance of payments of the United States.

The balance of payments generally shows a two-way flow of investment income. At the same time, for example, as some Americans lay claim to interest and dividends due from investments which they previously made in foreign countries, other Americans owe interest and dividends on investments which foreigners previously made in the United States. It is possible, therefore, for the *net* interest-and-dividend position of a country to be relatively small, despite large-scale borrowing-lending operations over a number of years. In most cases, however, there tends to be a decided balance of interest and dividends in favor of or against a particular economy. The present-day balance of payments of the United

[2] The service category is of major importance in the balances of payments of some countries. Switzerland, for example, is relatively resource-poor, but nevertheless enjoys a relatively high average standard of living. The latter has been made possible in part through that country's exploitation of its scenic attractions. Tourists who visit Switzerland use its transportation facilities, hotels, restaurants, etc., and in so doing they give Switzerland a payments-claim upon their resident country. The payments-claims arising from the expenditures of visiting tourists are no less a credit item in the Swiss balance of payments than are claims arising from the export of tangible merchandise, such as watches and precision instruments, the only difference being that the tourist receives the "export," i.e., an "export of scenery," inside the country. Similarly, prewar Norway, Greece, and Great Britain possessed very sizable merchant fleets and handled much of the world's ocean traffic, both passenger and freight. The rendering of shipping services gave these countries a payments-claim upon foreigners, and provided them with a large portion of the purchasing power required for payment of vital imports.

States, for example, shows a substantial net credit balance of interest and dividends. Similarly, the pre-World War II balance of payments of Great Britain showed a sizable credit balance on this score in consequence of earnings from her accumulation of foreign investments acquired during previous years. In contrast, the balances of payments of numerous underdeveloped countries, especially of those within which the more advanced countries have invested heavily during past years, show a net debit balance on investment income.

Interest and dividends are sometimes treated in the balance of payments as simply another form of service income, rather than as an entirely separate category. The logic for this treatment rests upon the premise that capital invested abroad renders a service, and that interest and dividends comprise the payment due for the services rendered by capital.

4. **Gifts.** Gifts of merchandise (e.g., Christmas parcels and relief supplies), sent by Americans to persons residing abroad, give rise to credit entries in the United States balance of payments, just as do merchandise exports. (Since no claim arises from a gift, an offsetting dummy debit entry is made at the same time under some special heading, e.g., under "donations.")

In another category, immigrants on occasion send remittances to assist their families who have remained abroad. These remittances may take the form of checks on American bank accounts, or of bank or postal money orders purchased in this country. The receipt abroad of such sums gives foreigners a claim upon an American person or bank, and therefore such transactions are handled as debits in the United States balance of payments. If the sums are spent in the purchase of merchandise from the United States, the physical export of goods may then be treated as a credit.

The government too may make gifts to foreigners. For example, the United States Government may grant credit to foreign countries who may then use this credit to obtain goods and services from the United States. The credit placed at the disposal of foreign countries enables them to draw upon the American economy; hence, the amount in question is entered as a debit in this country's balance of payments. Utilization of the line of credit gives rise to exports of goods and services from the United States, the value of which is then entered as a credit in this country's balance of payments. A simple way to visualize transactions of this type is as follows: what the United States gives is goods and services; such exports give rise to credit entries, and offsetting debit entries are made under an appropriate heading. Since gifts do not call for repayment,

the debit entries are commonly grouped under the label "*unilateral transfers,*" i.e., one-way transfers, or gifts. Recent examples include United States foreign aid under the Marshall Plan, and under the programs of the Mutual Security Agency and the Foreign Operations Administration.

5. **Long-term Investments.** Long-term investments are generally defined to include those whose duration is one year or longer.[3] Long-term foreign investments commonly include the purchase by residents of one country of private properties located abroad, e.g., factories, plantations, or mines, or of the securities of foreign governments or of private foreign corporations.

When a resident of the United States makes a long-term foreign investment, the transaction is treated as a debit in this country's balance of payments. A capital outflow is a debit for the United States because the foreign countries which receive the capital acquire a payments-claim upon this country. It may prove helpful to think of a capital export as a debit since it is accompanied by an importation of stocks, bonds, or other evidences of ownership and indebtedness.

Repayment of the foreign investments made in the past by residents of the United States gives rise to credit entries in this country's balance of payments. This is the case because the repatriation of capital serves to give the United States a payments-claim against one or more foreign countries.

In contrast, when residents of foreign countries make long-term investments in the United States, such capital inflows are shown as credit entries in this country's balance of payments. The logic is that a capital inflow serves to give this country a payments-claim upon foreign countries. Subsequent repayment constitutes a payments-claim upon the United States, and hence is treated as a debit in its balance of payments. Again, we may find it helpful to think of capital imports as exports of indebtedness (hence a credit) and of repayments as the reimportation of indebtedness (hence a debit).

6. **Short-term Investments.** Short-term investments are generally defined to include those whose duration is under one year.[4] Frequently the maturity date is only thirty, sixty, or ninety days in the future. Short-term foreign investments commonly include additions to foreign bank balances,

[3] U. S. Department of Commerce, *Balance of Payments of the United States, 1949-1951,* Washington, 1952, p. 93.

[4] *Ibid.*

purchases of certain types of foreign government bonds of relatively short maturity, and acquisitions of certain types of commercial paper.

When residents of the United States add to their foreign bank balances, or to their holdings of foreign short-term government or commercial obligations, this country is said to be exporting short-term capital. Capital outflows give rise to payments-claims upon this country, and hence are shown as debits in the United States balance of payments. On the other hand, when foreigners increase their bank balances in the United States, or increase their holdings of United States Treasury bills and commercial paper, they are in effect making short-term loans to the businessmen, banks, or government of this country. Such capital inflows give this country a payments-claim upon foreign countries, and hence are shown as credits in the United States balance of payments.

7. **Gold Movements.** The importation and exportation of gold are handled in the balance of payments in exactly the same manner as are merchandise imports and exports. When the United States (e.g., through the Treasury or one of the Federal Reserve Banks) purchases gold from abroad, the foreign seller acquires a payments-claim upon this country; hence the transaction gives rise to a debit entry in this country's balance of payments. An export of gold, on the other hand, is shown as a credit entry.

Actual physical shipment of gold need not occur, since "earmarking" operations suffice to account for changes in ownership. Earmarking is said to occur when a segment of the physical gold stock within one country is "set aside" for another country. No physical movement need occur; a bookkeeping entry is sufficient to acknowledge the shift in ownership. It is the purchase or sale of gold, rather than its physical movement, which is significant from the standpoint of the balance of payments.

8. **Currency Shipments.** United States currency exports, which currency frequently ends up in the private hoards of foreigners, are treated as a capital inflow, giving rise to a credit entry. The foreign purchase of United States dollars may not lead to the actual physical exportation of currency; rather, the funds may simply be transferred to a safe-deposit box in an American bank. It is the purchase of dollars, however, not their physical shipment, which is significant in the balance of payments.

Transactions of this type tend to be of relatively minor importance within the framework of the balance of payments. Since a great deal of secrecy frequently surrounds transactions of this type, balance-of-payments entries concerning them tend to reflect only the vaguest of guesses.

Typical Credit Transactions

A summary of those credit items which arise most frequently in the United States balance of payments includes the following:

Exports of merchandise

Services rendered foreigners:
- Foreign tourist expenditures in the United States
- Transportation services (passenger or freight) rendered foreigners
- Insurance, banking, and brokerage services accorded foreigners

Interest and dividend claims upon foreigners

Unilateral transfers (money-claim gifts, private or government) received from abroad

Long-term capital movements:
- New American securities (government or private) sold to foreigners
- Repurchase of foreign securities held in the United States
- Direct investments in the United States by foreigners
- Disinvestment by Americans of direct investments previously maintained abroad

Short-term capital movements:
- Increased foreign holdings of American short-term debts
- Decreased American holdings of foreign short-term debts
- Increase in foreign-owned bank balances in the United States
- Reduction of American bank balances abroad

Exports of gold

Exports of dollars

Transactions inverse to those indicated constitute debit items in the United States balance of payments.

Systematic Classification

A long list of transactions under the headings of "debit" and "credit" is not likely to tell us much about a country's international position. Nor is the total of all credit and debit items likely to reveal anything of importance for, as we shall see, the two are equal. It is the *relation between the various major categories* of debit and credit items which is of particular significance. It is important, therefore, that we group transactions within a few meaningful categories.

One time-honored method is to classify transactions as being either "visible" or "invisible." All transactions involving trade items which are

physically observable as they enter or leave a country may be termed visible. All other transactions, including those which occur outside the country or which do not readily meet the eye, may be classed as invisible. Merchandise trade, and possibly actual gold movements, thus comprise visible trade, while service and investment transactions constitute invisible trade. This distinction is perhaps interesting, but it is not particularly meaningful for the analysis of a country's international economic position.

Of greater significance is the type of classification previously referred to in itemizing typical United States transactions:

1. Merchandise trade
2. Services
3. Interest and dividends
4. Unilateral transfers
5. Long-term investments
6. Short-term investments
7. Gold movements
8. Currency shipments

This classification may be further condensed to include but three items: Merchandise (items 1 and 7[5]), Services (items 2 and 3), and Capital (items 4, 5, 6, and 8). The foregoing has the merit of extreme simplicity; it reveals in concise fashion that international transactions may, in the final analysis, assume only one of three basic forms: goods, services, or capital.

A highly meaningful distinction is sometimes drawn between those items which comprise the "Current Account" of the balance of payments and those which constitute the "Capital Account." The *Current Account* consists of payments for and receipts from transactions completed during the year in question. The *Capital Account*, on the other hand, reflects changes in the international investment or indebtedness position of a country. The distinction between the Current Account and the Capital Account is basically the same as that between income and capital. Income is a "flow" during a period of time, whereas capital is a "stock" accumulated over time. Similarly, *the Current Account summarizes current earnings and payments (during the year in question), whereas the Capital Account summarizes additions to, and subtractions from, a stock of investments or indebtedness accumulated over many years.*

The Current Account consists of merchandise (item 1), services (items 2 and 3), and unilateral transfers (item 4). The Capital Account con-

[5] Gold movements (item 7) are sometimes grouped in a separate category. It is quite logical, however, to place gold movements in the Merchandise category when gold moves as a commodity.

sists of long-term investments, short-term investments, and currency movements (items 5, 6, and 8). Gold movements (item 7) are sometimes treated as a third major classification (the "*Gold Account*"), on a par with the Current and Capital Accounts. When gold is purchased and sold as a commodity, however, it is quite logical to classify gold movements in the Current Account. Unilateral transfers are frequently grouped under the Current Account because the most significant thing about them is the transfer of goods and services which occurs. Sometimes, however, unilateral transfers are classified separately, giving rise to a fourth major category (the "*Unilateral-Transfer Account*").

THE BALANCE OF PAYMENTS ALWAYS BALANCES

A country's balance of trade may not balance, but its balance of payments always balances. By the *balance of trade* we mean the relation of merchandise exports to merchandise imports. When the value of a country's merchandise exports exceeds the value of its merchandise imports, the country is said to have a "favorable" balance of trade. When imports exceed exports in total value, on the other hand, the country is said to have an "unfavorable" balance of trade.

The balance-of-trade concept is intimately associated with the economic philosophy of *mercantilism,* which reached its peak popularity during the seventeenth century. The mercantilist philosophy, championed especially by Great Britain prior to her espousal of *laissez faire,* held that a country would benefit from a favorable balance of trade since the excess of exports over imports would be offset by an influx of precious metals (especially gold) which, it was believed, would then serve to enrich the country. Essentially, mercantilism was a business philosophy which held that it was better to sell than to buy. Its popularity rested largely upon the assumption that if the possession of money made an individual rich, the same must necessarily be true for a country. Its basic fallacy, of course, was the belief that money and wealth are synonymous. It does not follow, however, that mercantilism was an ill-advised policy, considering the environment of the period. A storehouse of gold was of considerable use to a country engaged in frequent warfare and heavily dependent upon paid mercenaries. Also, perhaps as a chance by-product, the monetization of gold inflows served to create and sustain a relatively long period of inflation, the effect of which was to augment profits and thereby to underwrite domestic economic expansion at a more rapid rate than otherwise possible.

While mercantilism as such has long since passed from the scene, "mercantilistic ideas" are far from dead. We do not have to look far to find persons who support a vigorous export policy, but who are prone to express alarm at any suggestion that imports be increased. In retrospect, however, it is unfortunate that a credit merchandise balance should have come to be labeled "favorable," for actually this situation need not be at all favorable for the country concerned. It would be far better simply to refer to the situation as a credit merchandise balance, thereby avoiding the implication that there is necessarily, or always, something favorable associated with it.

While merchandise imports and exports may not balance, the balance of payments in its entirety always balances. This is so because every transaction must be settled for in some manner (with the exception of an outright gift; a gift, as we have seen, is "balanced" in the balance of payments through inclusion of an offsetting dummy entry). We may demonstrate the inevitable balancing of accounts through a simple illustration involving only two countries, Country A and Country B, each of whom we may here assume uses the "dollar" as its currency unit. Under these conditions let us inquire what is likely to occur in the balance of payments of each country if a firm located in A imports merchandise valued at $1,000 from a firm located in B. The initial entries may be shown as follows:

	Country A		Country B	
	Credit	Debit	Credit	Debit
Merchandise trade	....	$1,000	$1,000	....

The merchandise trade of A shows a debit of $1,000 (imports), while merchandise trade in B shows an equivalent credit (exports). This, however, is not the end of the story. The exporter in B expects payment, while the importer in A must be prepared to make satisfactory settlement. Accordingly, *offsetting transactions occur in each country,* but the category under which the transactions fall depends upon the manner of settlement. If the importer pays in dollars, this payment represents a capital inflow (credit) for A and a capital outflow (debit) for B. Or, if the importer receives credit on the merchandise he has purchased, the "loan" is similarly shown as a capital inflow (credit) for A and as a capital outflow (debit) for B. As a result of either of the above transactions, the balance of payments of each country now appears as follows:

	Country A		Country B	
	Credit	Debit	Credit	Debit
Merchandise trade	. . . .	$1,000	$1,000	. . . .
Capital	$1,000	. . . .	. . . .	$1,000

There are, of course, additional means by which settlement may be effected. The above examples, however, suffice to illustrate the principle involved. Finally, it is well to recognize that at the same time as A imports merchandise from B, B may undertake purchases in A. The latter transactions, too, are handled in similar fashion to those described: every transaction leads to both a debit entry and a credit entry in the balance of payments of each of the two countries.

The essential fact is that in each of the countries, total debits must equal total credits. There need be no "balance" between each major category of accounts, but the aggregate of all accounts — the Current Account, the Capital Account, the Gold Account, and Unilateral Transfers — must, of necessity, show an identity of total debits and credits. If total debits exceeded total credits in a given country's balance of payments, this situation would automatically imply that the country had received something (other than a gift) without settling for it, even in a temporary manner, or it would indicate that some transaction, or transactions, had not been taken into account. In practice, a slight discrepancy may exist, an amount which is normally treated under the heading of "errors and omissions." Such a discrepancy occurs only because of our inability to trace all transactions. If we have complete information concerning all transactions, however, total debits exactly equal total credits.

The foregoing illustration involved only two countries. In the examples, all of A's obligations were to B, payable only by receipts from B, and vice versa. In the real world, matters are rarely this simple. Great Britain may, for example, make payments in the United States with receipts from transactions with Brazil, while Brazil may make payments to Great Britain out of receipts from transactions with the United States, etc. Some of the world's trade is multilateral, not bilateral, in nature (at one time almost exclusively so). The essential facts established in the case of two countries, however, are equally true under multilateral trading conditions. Under all circumstances, (1) *every debit in a country's balance of payments is matched by a credit in another country,* and vice versa, and (2) *every debit in a country's balance of payments is matched by a credit within the same country,* and vice versa.

DEFICITS AND SURPLUSES

While a balance of payments always balances, we frequently hear it said that a particular country has a "deficit" or a "surplus" in its balance of payments. In recent years, for example, the British balance of payments has shown a persistent deficit, while that of the United States has shown a surplus. The terms "deficit" and "surplus" in these cases refer to the relationships between total debits and total credits, *exclusive* of those debits or credits which arise from transactions undertaken for the specific purpose of bringing accounts into balance.

A deficit is said to prevail when a country's total payments-receipts are insufficient to cover the country's total payments-obligations, so that additional transactions become necessary to bring the accounts into balance. Such additional transactions typically include the export of gold and withdrawals from bank balances held abroad; when the deficit is large-scale and persistent, the receipt of grants from abroad may be (and frequently is) required to preclude drastic curtailments in importation. A surplus, on the other hand, is said to exist when the balance of payments is brought into balance only through inclusion of special "balancing" transactions, such as the receipt of gold, the acquisition of additional foreign assets, and the outright extension of donations.

Transactions undertaken for the sole purpose of equalizing accounts are frequently referred to as *induced* transactions, being "induced" by the absence of an equivalence between the other or *autonomous* transactions in the balance of payments. A balance of payments which shows a deficit may also be labeled *passive;* the induced transactions which evoke balance frequently constitute withdrawals from assets acquired during earlier periods when the balance of payments was *active*, i.e., when a surplus prevailed.

The existence of a deficit or a surplus in a country's balance of payments is frequently regarded as a danger signal, although there need not inevitably be cause for alarm. Before any conclusion on this score is drawn, it is important first to appraise the situation carefully to ascertain the direction, amount, and possible duration of the discrepancy, as well as the specific items in the balance of payments largely responsible for the situation. In general, surpluses do not raise questions of the same magnitude as do deficits, nor need all deficits be regarded with equal concern. Temporary deficits of slight magnitude are not unusual, and ordinarily they raise no special questions. In cases, however, where the financing of deficits requires heavy withdrawals from foreign bank bal-

ances, the liquidation of other assets held abroad, resort to foreign borrowing, or reliance upon foreign grants, the question immediately arises as to just how long this situation may be safely continued. Since such means of financing are *non-sustainable* in character, government action may well be deemed necessary, especially if the deficit is sizable, and is also likely to persist. Remedial measures commonly suggested under such circumstances include the pursuit of deflationary domestic policies, the introduction of import controls, and/or a revision in the value of the country's currency unit in terms of foreign currencies (i.e., a revision in the exchange rate so as to alter the terms of trade).

THE UNITED STATES BALANCE OF PAYMENTS

Table 15 shows the United States balances of payments for 1929, the last year of the "golden twenties," and for 1939, the year in which World War II began in Europe. Table 16, in turn, shows the balances of pay-

Table 15

Balance of Payments of the United States, 1929 and 1939 (millions of dollars)

	1929		1939	
	Credit	Debit	Credit	Debit
I. Current Account:				
Merchandise trade	5,241	4,399	3,157	2,318
Other current transactions:	1,906	1,962	1,157	1,264
Interest and dividends	982	330	541	230
Other service income	924	1,632	616	1,034
II. Capital Account:				
Long-term capital movements:				
Through changes in U. S. assets abroad	381	1,017	166	53
Through changes in foreign assets in the U. S.	378	20	. . .	86
Short-term capital movements:				
Through changes in U. S. claims abroad	. . .	200	211	. . .
Through changes in foreign claims on the U. S.	196	. . .	1,259	. . .
III. Gold Movements:				
Net gold exports or imports	. . .	175	. . .	3,574
Net change in earmarked gold	55	. . .	556	. . .
Errors and omissions	. . .	384	789	. . .
Total	8,157	8,157	7,295	7,295

Source: U. S. Department of Commerce, *The United States in the World Economy*, Washington, 1943, Tables 1 and 3, Appendix. Data rearranged.

ments for the post-World War II years, 1946-53. One notable change, postwar as compared to prewar, is the larger dollar entries during the postwar years, reflecting the impact of inflation and the growing world importance of the United States. The essential relationships between the various categories of transactions, however, are basically unchanged.

Probably the outstanding single feature of the United States balance of payments is the export surplus which it shows. As we observed earlier, this country has had a merchandise export surplus in each and every year during this century. During the post-World War II period, the net credit surplus on current account (goods and services) assumed major proportions, varying from a minimum of over \$2 billion to a maximum of over \$11 billion per year. In 1947, the export surplus on current account actually amounted to over 50 per cent of the total of all credit (or debit) items!

What sustains export surpluses of the amounts cited? During the 1930's, especially from 1933 to the outbreak of World War II, the United States imported much of the world's gold through its gold purchase program, the country's total gold holdings being increased by more than \$12 billion between 1934 and 1940 alone. The importation of gold (a debit in the United States balance of payments) provided a major source of payment for the country's export surplus on current account (credit balance). Since World War II, however, the export surplus has been supported in large part by the foreign-aid programs of this country. Unilateral transfers (i.e., government grants), exceeding \$2 billion in every postwar year (1946-53), and exceeding \$5 billion in three of these years, have provided the debit which in large part served to offset the export surplus on current account. In short, some portion of the exports of the United States during the latter period occurred only because of this country's willingness to extend gifts.

THE BILATERAL BALANCE OF PAYMENTS

As we have seen, a country's balance of payments summarizes all transactions between it and the rest of the world during a given time interval. The balance-of-payments form is sometimes modified, however, to permit an analysis of special problems. Thus, while we may be interested in determining the position of a country with respect to the total of its international transactions, we may also wish to know something about its position vis-à-vis only one other country, or one small group of countries. A summary restricted to transactions between two countries, or one country and a group of a few other countries, is known as a

bilateral balance of payments. This form proves helpful in showing the interrelationship of the transactions of two countries, especially when the foreign trade of each is heavily concentrated in the direction of the other. For example, a bilateral balance of payments of the United States vis-à-vis Great Britain would enable us to show in precise fashion the amount and nature of payments deficits (or surpluses) between these two countries, exclusive of those transactions undertaken by each with the remainder

Table 16

Balance of Payments of the United States, 1946-1953

(millions of dollars)

	1946		1947		1948	
	Credit	Debit	Credit	Debit	Credit	Debit
Merchandise (adjusted)[1]	11,707	5,073	16,015	5,979	13,193	7,563
Services [1]	2,235	1,172	2,594	1,483	2,225	1,653
Income on Investments	772	212	1,102	245	1,340	280
Military items [2]	69	493	43	455	300	799
Goods and Services (total)	14,783	6,950	19,754	8,162	17,058	10,295
Unilateral Transfers (net)	. . .	2,997	. . .	2,650	. . .	4,807
United States Capital (net):						
Long-term						
Private	. . .	103	. . .	798	. . .	790
Government	. . .	3,262	. . .	6,856	. . .	1,112
Short-term						
Private	. . .	310	. . .	189	. . .	116
Government	238	. . .	. . .	113	88	. . .
Foreign Capital (net):						
Long-term	. . .	347	. . .	98	. . .	172
Short-term	. . .	633	363	. . .	524	. . .
Gold Purchases or Sales (net)	. . .	623	. . .	2,162	. . .	1,530
Errors and omissions	204	. . .	911	. . .	1,152	. . .
Total	15,225	15,225	21,028	21,028	18,822	18,822

[1] Excludes military expenditures.

[2] Includes goods and services. Credit entries refer to military transfers under U. S. aid programs; debit entries refer to foreign military expenditures in the U. S.

of the world. The *Survey of Current Business,* published monthly by the United States Department of Commerce, each year presents the United States balance of payments, both as a total and in bilateral form vis-à-vis the United Kingdom, Canada, Western Europe, Latin America, etc.

Similarly, we may also construct a *regional balance of payments.* The region in question may consist of a number of countries, such as when we

treat Latin America or Western Europe as single units, or it may comprise a portion of a single country. In the latter instance, the regional balance of payments summarizes the transactions occurring between residents of a particular region within a country and residents of the rest of the same country and of all foreign countries. For example, a balance of payments for Texas would include transactions between that state and the "rest of the world," in this case meaning the forty-seven other states and all foreign countries. For all practical purposes, all transactions crossing the Texas border would then be regarded as "foreign" transactions. A balance of payments constructed along these lines would prove helpful in showing the extent to which, and the manner in which, a particular region draws upon other regions for its livelihood, or is "drawn" upon. The regional

1949		1950		1951		1952		1953	
Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit
12,149	6,879	10,117	9,108	14,123	11,202	13,319	10,838	12,383	10,954
2,279	1,828	2,160	2,024	2,807	2,241	2,911	2,503	2,670	2,523
1,395	333	1,593	345	1,882	355	1,828	390	1,931	451
210	621	526	576	1,470	1,270	2,603	1,957	4,281	2,496
16,033	9,661	14,396	12,053	20,282	15,068	20,661	15,688	21,265	16,424
. . .	5,839	. . .	4,544	. . .	4,987	. . .	5,137	. . .	6,707
. . .	740	. . .	1,116	. . .	965	. . .	1,064	. . .	544
. . .	479	. . .	119	. . .	153	. . .	418	. . .	231
187	. . .	. . .	149	. . .	103	. . .	94	167	. . .
. . .	173	. . .	37	. . .	3	. . .	2	11	. . .
119	. . .	994	. . .	. . .	477	443	. . .	125	. . .
. . .	47	918	. . .	1,055	. . .	1,169	. . .	981	. . .
. . .	164	1,743	. . .	. . .	53	. . .	379	1,163	. . .
764	. . .	. . .	33	472	. . .	509	. . .	194	. . .
17,103	17,103	18,051	18,051	21,809	21,809	22,782	22,782	23,906	23,906

Source: U. S. Department of Commerce, *Survey of Current Business*, Washington, July, 1954, pp. 14-15. Data rearranged.

balance of payments of a state would, among other things, show the inflow and outflow of capital, the inflow and outflow of earnings from capital, the income withdrawn from the state through federal taxation, and the funds returning to the state as grants-in-aid, as expenditures in the construction and maintenance of defense installations, and as the salaries of those residents on the federal payroll.

MAKING AN INTERNATIONAL PAYMENT

The balance of payments consists of a relatively few major categories of transactions. The approach is aggregative; many transactions are grouped under each of a few headings. Let us, therefore, digress briefly from the foregoing analysis to illustrate how an individual foreign-trade transaction is negotiated. While there are several possible methods, the following procedure is representative and serves to illustrate the fundamental process.

Assume that an American importer wishes to purchase textiles worth £1,000 (one thousand pounds sterling) from a British firm, but that he is unknown to the exporter. A usual way to handle the transaction is for the American to visit his bank, say the Chase National Bank of New York (or any bank having correspondent bank connections in New York), and arrange for a letter of credit to be opened in favor of the British exporter. In extending the letter of credit, the bank in effect substitutes its credit for that of the importer, and agrees to honor certain foreign claims which will subsequently be made upon it. In return for this assumption of liability, the bank acquires a claim upon the importer. The latter claim is stated in dollars, the price of £1,000 being perhaps $2,800 plus a small additional fee for services rendered. (In the next chapter we shall see how the price of one currency in terms of another is determined.)

Once a line of credit is extended, the following sequence of developments occurs: (1) The Chase Bank sends the letter of credit to the British exporter. This action is intended to assure the exporter that he will receive payment for his goods. (2) Upon shipment of the merchandise, the exporter draws a draft upon the Chase Bank, which document represents an order for the Chase Bank to pay dollars worth £1,000. The exporter sells this draft to his local bank for pounds sterling at a discount, and presumably acquires a demand deposit. (3) The British bank forwards the draft, along with documents verifying shipment of the merchandise, to its correspondent bank in New York, requesting that collection be made. (4) The correspondent bank, in turn, forwards the draft, along with supporting documents, to the Chase Bank and, upon maturity of the draft, receives dollars in payment on behalf of the British bank. (5) The Chase Bank next makes the shipping documents available to the importer so that he may claim his merchandise from the shipping firm. The importer also has to settle for transport costs before receiving his merchandise, provided the goods were purchased f.o.b. Great Britain, and he has to settle with customs authorities. (6) Finally the importer settles with the Chase

Bank, presumably by check, resulting in a withdrawal from his demand deposit.

In the reverse case, if a resident of Great Britain wishes to import merchandise, say machinery, from the United States, a common procedure is for the prospective importer to purchase dollars held by a British bank in its correspondent bank in the United States. The British importer pays for the dollars by drawing upon his deposits of pounds sterling, while the American exporter receives payment in dollars from the American dollar-holdings of the British bank.

It is significant to note that individual transactions may be completed without anyone having to ship gold or currency. Financial settlement is accomplished through the facilities of the banking system. For example, in the case of an American import from Great Britain, British holdings of dollar assets in New York are increased, while bank holdings of pounds sterling in Great Britain are decreased; an American export to Great Britain produces opposite effects. It is significant also to note that the operation of the banking system makes it possible for the importer to receive credit and eventually to pay in terms of his national currency, while the exporter is able to receive payment immediately and in terms of his national currency. The banking institutions concerned, of course, derive income from the sale of the services they offer.

WHAT THE BALANCE OF PAYMENTS SHOWS: A RÉSUMÉ

What does the balance of payments of a country show? At an earlier point in this chapter the statement was made that the balance of payments provides a record which enables us to get a better understanding of a country's overall international economic position. Specifically, it was stated that (1) the magnitudes of the various classifications of transactions reveal how a country "pays its way" internationally, and that (2) the interrelation of the major classifications of transactions may reveal important facts concerning a country's role within the context of the world economy.

The manner in which a balance-of-payments statement reveals information of the foregoing types may be demonstrated in simple fashion by means of an analogy. In a sense, a balance-of-payments statement is like a budget which a person might devise for himself. A personal budget covering a year may be arranged to show sources of "income" in one column and types of "outgo" in another column. In similar fashion, a country's international receipts (credits) and international payments (debits) may be shown in two columns. The Current Account (exclusive

of unilateral transfers) shows the current income-expenditure status of a country.

A person may save and invest some of his income, or he may spend so heavily that he is forced to draw upon his past savings or to borrow in order to supplement present income. A country may find itself in the same situation. If the Current Account (exclusive of unilateral transfers) does not balance, and there is no particular reason why it should, offsetting transactions show up elsewhere in the balance of payments (e.g., in the Capital and Gold Accounts, or under Unilateral Transfers).

When a person's current outgo exceeds his current income, we do not necessarily conclude that he is headed for bankruptcy. Before forming an opinion, we need logically to examine his financial position more closely. If we find that he has borrowed to undertake investments which may later increase his income, we are likely to conclude that he is on sound ground. If, however, we find that he has borrowed (or drawn upon past savings) in order to maintain consumption at a level higher than otherwise possible, we are likely to conclude that he must do something to change matters or face serious financial trouble later on. A country, too, may develop an import surplus of goods and services (i.e., its current payments-obligations may exceed its current payments-receipts). The logical question then concerns the country's overall situation, something which we can readily discern from its balance of payments. Any one, or any combination, of the following types of transactions may offset the import surplus: (1) the receipt of long-term capital, (2) the receipt of unilateral transfers, (3) withdrawals from assets held abroad, (4) the export of gold, or (5) the use of short-term credit. The country's position will differ a great deal, however, depending upon which one of the foregoing is relied upon. We may briefly examine each of them.

The existence of an import surplus, paralleled by the (net) receipt of long-term capital, is not, in and of itself, to be viewed with alarm. The use of such capital may serve to increase the country's export potential at some future time. In short, the receipt of long-term capital is no different for a country than is private long-term borrowing for the purpose of acquiring assets which serve to increase one's future income potential.

When an import surplus is offset by any one or more of the other four types of transactions, however, the country's economic position is somewhat different. In a sense, all four are stopgap in nature. There is a question as to how long they may be relied upon. Unilateral transfers are largely dependent upon the willingness of another country, or countries, to continue to make them. Immigrant remittances are likely to prove more enduring, but they generally do not loom large in the total scheme

of things. Withdrawals from assets held abroad or exports of gold cannot continue indefinitely, since the supply of such resources has a finite limit. An inflow of short-term capital is not apt to continue indefinitely, and may, in fact, readily change direction. Therefore, since these means of financing are *non-sustainable* in nature, a country which relies upon them to offset its import surplus must presumably undergo some changes eventually. Its position is akin to that of a private person who is currently living "beyond his means." (An analysis roughly opposite in nature applies to a country having an export surplus on current account.)

We may conclude, therefore, that when a country having a deficit in its balance of payments balances its accounts by means of non-sustainable means, it is not in equilibrium; it is not making "ends meet." If such a deficit is large and persistent, some form of adjustment becomes necessary. In the following chapters, one of our tasks is to discover *what* developments become likely or possible.

SUMMARY

The balance of payments is a summary statement of all economic transactions completed between the residents of one country and the residents of other countries during a given period of time, usually a year. Transactions may be classified as either "credit" or "debit," depending upon whether they add to, or subtract from, a country's payment-claims upon other countries. Transactions may be further grouped within a few economically meaningful categories: (1) the Current Account, which summarizes a country's earnings and payments during a given year, (2) the Capital Account, which summarizes additions to, or subtractions from, a country's stock of foreign investments, (3) the Gold Account, which indicates monetary gold movements, and (4) the Unilateral-Transfer Account, which indicates the amount and direction of grants, private and public.

A country's balance of payments always balances. This is necessarily so because every debit has a credit, and vice versa. Despite the inevitable balancing of a country's international accounts, the balance of payments may show a deficit or a surplus. A deficit is said to exist, for example, when total autonomous debits exceed total autonomous credits, i.e., the equality between total debits and total credits is possible only because of certain induced transactions.

Probably the most outstanding feature of the United States balance of payments is its merchandise export surplus. The merchandise credit balance was largely offset for some years by gold imports (debit balance), but in recent years has been offset largely by unilateral transfers (debit

balance). The latter have consisted almost entirely of United States Government grants to foreign countries under various foreign-aid programs.

SELECTED REFERENCES

Haberler, G., *The Theory of International Trade.* New York: The Macmillan Company, 1950, Chap. II.

°International Monetary Fund, *Balance of Payments Yearbook,* Washington. (Published annually.)

°Meade, J. E., *The Balance of Payments,* Vol. 1. New York: Oxford University Press, 1951, Part I.

°Southard, F. A., *Foreign Exchange Practice and Policy.* New York: McGraw-Hill Book Company, Inc., 1940, Chap. I.

U. S. Department of Commerce, *The United States in the World Economy,* Washington, 1943.

4

The Rate of Exchange

A BASIC DIFFERENCE between domestic trade and international trade is that the former is conducted in terms of a single currency while the latter involves two or more currencies. In carrying on their operations, exporters acquire claims to foreign currency which they seek to exchange for domestic currency; similarly, importers possess domestic currency but require claims to foreign currency in order to settle for purchases made abroad. How can each exchange the currency he holds for the currency he desires? One possible way is for the importer who wishes to acquire claims to foreign currency to contact the exporter who holds such claims. There are several reasons, however, why this procedure does not offer a practical solution. First, the importer and exporter may be entirely unknown to one another, and may in fact live in far separated localities. Second, the importer may not desire the exact amount in claims to foreign currency which the exporter has to offer, nor may he desire it at the precise moment it is for sale. Third, the importer may require short-term credit on his purchase of claims to foreign currency, but the exporter may desire immediate payment for any such claims he offers for sale. Finally, the particular foreign currency an exporter has claim to may not circulate freely in the country in which the importer desires to make payment. Since there are today over fifty separate currency systems in the world, over twenty in Europe alone, the likelihood of successful barter in cur-

rency-claims between pairs of traders is not very promising. Clearly it is not practical for individual importers and exporters to deal with one another directly, and for this reason foreign payments have come to be handled in another and more organized manner.

THE FOREIGN-EXCHANGE MARKET

Because it is impractical for persons to attempt on their own initiative to offset one another's claims, a specialized market has developed for the express purpose of facilitating such transactions. This market in which claims to foreign moneys are bought and sold in terms of domestic money is known as the *foreign-exchange market.* To put it more precisely, the commodity handled in the foreign-exchange market is *foreign exchange,* by which we mean all those credit instruments which give residents of one country a claim upon money, or purchasing power, in another country. One such credit instrument is the *bill of exchange* or draft, an order drawn by the exporter instructing the foreign importer (or his bank) to pay a certain sum to the exporter. The transmittal of such a credit instrument enables the importer to arrange payment in terms of his own currency, and enables the exporter to receive immediate payment in his national currency. In Chapter 3 we illustrated the mechanics of such a transaction. The essential principle illustrated there applies to each of the various types of credit instruments used.

The foreign-exchange market consists of the foreign-exchange bankers and the foreign-exchange departments of commercial banks who buy and sell foreign exchange, plus the treasury and the central bank who may on occasion also intervene to affect the purchase and sale of foreign exchange. New York is the focal point of the market within the United States, but there is also some concentration in New Orleans of foreign-exchange transactions with Latin America and in San Francisco of foreign-exchange transactions with Asiatic countries. Banks and dealers in other parts of the country maintain correspondent connections with the major centers, especially with New York, and are therefore able to buy and sell foreign exchange in their own localities. Similarly, London, Paris, Rome, and other cities are the focal points for foreign-exchange dealings involving residents of the countries in which these cities are located.

The basic function of the foreign-exchange market is to transfer purchasing power from one country to another. The manner in which this is accomplished is similar to the transfer of purchasing power within a country. Students of economics are generally familiar with the process by which checks drawn on New York banks and paid to residents of, say, San Francisco are cleared within the Federal Reserve System against

checks drawn on San Francisco banks and paid to New York residents. For the greater part, the claims of the San Francisco Federal Reserve District upon the New York Federal Reserve District cancel out the New York claims upon San Francisco, or vice versa, after which any uncleared balance is dealt with through transactions with the Interdistrict Settlement Fund maintained in Washington. The foreign-exchange market operates on essentially the same clearing-house principle. For example, New York foreign-exchange dealers stand ready to pay dollars for, say, the sterling-claims acquired by American exporters in their transactions with Great Britain, and at the same time the dealers stand ready to sell to American importers for dollars the sterling-claims so obtained. Similarly, foreign-exchange dealers in London stand ready to pay pounds sterling for the dollar-claims acquired by exporters, and such dollar-claims may then be sold for pounds sterling to importers desiring to make payments within the United States. Simplifying further, the bill of exchange received by an American exporter from a British importer may be purchased by an American importer who wishes to make payment in Great Britain. The American importer in effect pays dollars to the American exporter; the British exporter in reality collects sterling from the British importer. Payment for the great bulk of transactions occurs simply through the simultaneous clearing of the many debts owed in both directions. In so far as clearing is possible, it is importers who, for all practical purposes, pay exporters within each country.

Clearing need not be bilateral but, just as in the case of bank clearances within a country, may be conducted on a multilateral basis. For example, Brazil may earn dollars from its sales of coffee to the United States, Brazilians may use these dollars to pay for imports of British textiles, and British importers may, in turn, use the same dollars to pay for foodstuffs imported from the United States. United States exports to Great Britain may thus serve to pay for United States imports from Brazil. The process of clearing becomes quite intricate when many countries are concerned, but the essential principle involved is identical to that illustrated in the case of triangular trade. In short, whether trade is bilateral or multilateral, the foreign-exchange market acts as a clearing house for foreign exchange, and through this clearance of foreign exchange purchasing power is transferred from one country to another.

THE RATE OF EXCHANGE

Buyers and sellers of goods and services within a country need to concern themselves with but one price, i.e., the price of the goods and services themselves. This is so because all prices are quoted in terms of

the single domestic currency. In international trade, however, buyers and sellers need to concern themselves with no less than two prices, i.e., the price of the goods and services *and* the price of foreign exchange. For example, an American desiring to import a British automobile needs to consider not only the sterling price of the automobile, but also the dollar price of sterling. This second price, the price which must be paid in domestic currency in order to obtain a unit of foreign currency, is known as the *rate of exchange*. Thus, a New York rate of $2.80 on London means that the New York dollar price of sterling is $2.80 per British pound. A rate of exchange prevails between every pair of currencies, and this rate may be expressed in terms of either currency. For example, the New York price of one British pound may be $2.80, while its Paris price may be 980 francs; the London price of one dollar may be 0.357 pounds, while its Paris price may be 350 francs; and the London price of one franc may be roughly 0.001 pounds, while its New York price may be roughly $0.003. The value of each currency unit is a reciprocal of the other, e.g., £1=$2.80 and $1=£0.357.[1] (Table 17 indicates prevailing *official* rates of exchange between the United States dollar and the currency units of a group of selected countries. From the standpoint of a foreign trader, however, there generally is no single exchange rate for a particular currency; rather, the rates which prevail in the *market* tend to differ somewhat from the official rate and from one another. This situation arises because foreign exchange is represented by several types of credit instruments, each of which tends to sell at a slightly different rate. Such differences ordinarily are not great, and tend to be held at a minimum through the operation of market forces.)

What precisely determines the dollar price of sterling, the sterling price of dollars, etc.? Our preliminary answer must be that the rate of exchange is a price (of one money in terms of another) and that, like any other price in a free market, it is determined by the interaction of the forces of supply and demand. That is, the rate of exchange is a price determined by the interaction of supply-and-demand forces as the latter pertain to a particular category of foreign exchange. This answer only scratches the surface, however, and really doesn't carry us very far. More basic questions remain: What makes the supply of foreign exchange what it is? What makes the demand for foreign exchange what it is? And why do supply and demand change? Again we may answer that the supply of foreign exchange reflects the payments-receipts summarized in the balance of payments, while foreign exchange is demanded to meet the payments-

[1] Great Britain does not use the decimal system. Amounts are shown in this manner for reasons of simplicity.

Table 17

Exchange Rates (Official Par Values), Selected Countries
(May 15, 1954)

Country	Currency	U.S. Cents per Currency Unit	Currency Units per U.S. Dollar
Australia	Pound	224.	.446
Austria	Schilling	3.846	26.
Belgium	Franc	2.	50.
Bolivia	Boliviano	.526	190.
Brazil	Cruzeiro	5.405	18.5
Ceylon	Rupee	21.	4.762
Chile	Peso	.909	110.
Colombia	Peso	51.282	1.95
Costa Rica	Colón	17.809	5.615
Cuba	Peso	100.	1.
Denmark	Krone	14.478	6.907
Dominican Republic	Peso	100.	1.
Ecuador	Sucre	6.667	15.
Egypt	Pound	287.156	.348
El Salvador	Colón	40.	2.5
Ethiopia	Dollar	40.25	2.484
Finland	Markka	.435	230.
Germany, Fed. Rep.	Deutsche Mark	23.81	4.2
Guatemala	Quetzal	100.	1.
Honduras	Lempira	50.	2.
Iceland	Króna	6.14	16.286
India	Rupee	21.	4.762
Iran	Rial	3.101	32.25
Iraq	Dinar	280.	.357
Japan	Yen	.278	360.
Lebanon	Pound	45.631	2.191
Luxembourg	Franc	2.	50.
Mexico	Peso	8.	12.5
Netherlands	Guilder	26.316	3.8
Nicaragua	Córdoba	20.	5.
Norway	Krone	14.	7.143
Pakistan	Rupee	30.225	3.309
Panama	Balboa	100.	1.
Paraguay	Guaraní	6.667	15.0
Philippines	Peso	50.	2.
Sweden	Krona	19.33	5.173
Syria	Pound	45.631	2.191
Turkey	Lira	35.714	2.8
Union of South Africa	Pound	280.	.357
United Kingdom	Pound	280.	.357
United States	Dollar	100.	1.
Venezuela	Bolivar	29.851	3.35
Yugoslavia	Dinar	.333	300.

Source: IMF, *International Financial Statistics*, Washington, June, 1954, pp. 2-3. Amounts rounded at three decimal places.

obligations summarized in the balance of payments. In other words, the status of a country's balance of payments determines its supply of and demand for foreign exchange, and the interaction of the supply-and-demand forces in turn yields the going rate of exchange vis-à-vis other currencies. The "catch" in all this is that, while the supply of and the demand for foreign exchange may determine the rate of exchange, the latter in turn is *the* big factor determining the supply of and the demand for foreign exchange. In short, the rate of exchange is an *effect* of the supply-and-demand forces summarized in the balance of payments, but it also is a *cause* of shifts in these same supply-and-demand forces!

Needless to say, the matter of cause and effect between the exchange rate and the status of the balance of payments strikes at the very core of our subject. At this stage we may proceed to examine, *in a narrow sense,* how the rate of exchange is determined, leaving the broader, and more complex, question of how the rate of exchange and the balance of payments are interrelated to the following chapter. Basically, we may distinguish two distinct sets of conditions under which the determination of exchange rates occurs: (1) under gold-standard currencies, and (2) under inconvertible-paper currencies. The types of exchange-rate systems associated with these conditions are as follows: (*a*) "fixed" exchange rates under (1), and (*b*) either "fluctuating" exchange rates or "exchange control" under (2).

EXCHANGE RATES UNDER THE GOLD STANDARD

Two essential conditions characterize an international gold standard. First, within each gold-standard country gold serves as the standard of value, the value of the country's basic monetary unit being defined in terms of gold. Second, each gold-standard country freely permits gold imports and exports, such movements in turn being allowed to increase or decrease the supply of money and credit. Since each currency is defined in terms of gold, and since gold is free to move between countries, the currencies of the various gold-standard countries are linked to one another. The basic feature of the international gold standard is this *link* maintained between countries through the free international movement of gold.

Before 1914, most of the leading commercial countries of the world adhered to the international gold standard; between 1924 and the Great Depression, the gold standard again prevailed, although in modified form (the second essential condition cited above was not fully met). Today no country is unequivocally upon a gold standard, and such a system may never return, at least not in the form once known. Some knowledge

of the mechanics of the system, however, may still be of use to us, not only because such knowledge may give us a better understanding of the working of the present-day systems, but also because of the fuller appreciation we may thereby have of the varied views held on the gold standard today. Many persons, including some well situated in the financial world, continue to decry the abandonment of the international gold standard, pointing out reasons why it should be restored. Others, who have never mourned its demise, allege either that the system did not work or that the manner in which it worked entailed too many painful consequences.

Under gold-standard conditions, the rate of exchange is determined by the interaction of the forces of supply and demand as these relate to foreign exchange; however, the fluctuations which occur in the rate of exchange in consequence of changes in supply and demand are relatively small, the actual rate of exchange hovering about a "norm" set by the ratio of the gold contents of the monetary units of the particular pair of countries in question. This is the basis for saying that the rate of exchange under a gold standard is "fixed." We may illustrate these basic principles. For example, prior to World War I the British pound sterling was defined as containing 113.0016 grains of fine gold and the United States dollar was defined as containing 23.2200 grains of fine gold; therefore, the gold value of the pound was 4.8665 times that of the dollar, and hence the official exchange rate of dollars to pounds, i.e., the "mint parity" of exchange, was $4.8665 per pound sterling. Either of the two countries could change the official rate of exchange (i.e., mint parity) between its currency and that of the other simply by altering the physical gold content of its monetary unit (or by altering its buying and selling price of gold, which amounts to the same thing).

The rate of exchange which actually prevailed in the foreign-exchange market generally varied somewhat from the mint-parity figure, although by only a slight amount. Whenever the demand for foreign exchange exactly equaled the supply becoming available, the effective rate of exchange between, say, the pound sterling and the dollar tended to be at (or generally very near) mint parity: £1=$4.8665 (plus a slight charge by foreign-exchange dealers for services rendered). Whenever, however, American imports increased so that the demand for sterling bills exceeded the supply becoming available at this rate, the dollar price of sterling tended to be pushed upwards, say toward £1=$4.89. While the dollar price of sterling tended under the circumstances to rise in the manner indicated, the amount of increase was limited by virtue of an alternative avenue open to those demanding sterling. Those persons who held dollars but who desired sterling were free either to buy sterling in the foreign-

exchange market *or* to buy gold from the treasury for shipment to London. Persons desiring to transmit payments naturally followed whichever of the two courses provided them with the desired means of payment most cheaply. The shipment of gold involved an expense for freight, insurance, packaging, loss of interest while in transit, etc. Whenever the New York price of sterling exceeded mint parity by more than the cost of shipping an equivalent value in gold, it became less costly for the potential demanders of sterling actually to ship gold in payment of their foreign obligations than to purchase foreign exchange from foreign-exchange dealers. Since foreign-exchange dealers are in business for profit, it was to their advantage not to be by-passed by allowing their wares to be priced out of the market. In practice, therefore, it was dealers who on occasion shipped gold in order to buy sterling. The sterling proceeds so obtained, when deposited to their accounts in London, enabled dealers to continue to sell sterling for dollars in New York. This point at which foreign exchange became sufficiently costly to warrant gold exports was known as the *gold export point.* During the years the United States adhered to the international gold standard, the dollar price of sterling beyond which gold tended to be exported was in the vicinity of £1=$4.89, or roughly 2¢ per pound sterling above mint parity.

Conversely, whenever American exports increased so that the supply of sterling bills being accumulated exceeded the demand for them at the prevailing rate of exchange, there was a tendency for this rate to be pushed below mint parity. In practice, the exchange rate tended to decline toward a minimum of about £1=$4.84, or some 2¢ per pound sterling below mint parity, but at this point gold commenced to flow to the United States from Great Britain in preference to the continued purchase of dollars with sterling. This lower limit of the exchange rate at which gold imports occurred was known as the *gold import point.*

We thus observe, first, that the rate of exchange under the gold standard was "fixed" in the sense that it was not free to fluctuate except within limits set by the gold points. The spread between the gold points depended upon the cost of transporting gold. To the extent that the earmarking of gold by central banks in their dealings with one another came to replace the physical movement of gold, the spread between the gold points was considerably lessened and fluctuations in the exchange rate reduced accordingly. Second, we observe that the movement of gold (through physical shipment or through earmarking operations) under the gold standard enabled a country to replenish its foreign-exchange supplies. A country was in no danger of running out of foreign exchange as long as it had gold to export. Only if a country completely exhausted

its gold stocks was it prevented from acquiring additional supplies of foreign exchange. Before such an impasse arose under the gold standard, however, various corrective forces (discussed in the following chapter) presumably came into play.

EXCHANGE RATES UNDER INCONVERTIBLE-PAPER CURRENCIES

The international gold standard was succeeded by the adoption in individual countries of "paper standards" (i.e., independent systems of inconvertible paper). The latter currency systems, with some important modifications, have continued to exist until the present time. Under inconvertible paper, the nominal value of a country's monetary unit commonly continues to be expressed in terms of gold, but gold no longer circulates freely within countries, nor does it move between countries except under closely controlled conditions.

Since the "standard of international value" provided by gold under the international gold standard is absent when countries adhere to systems of inconvertible paper, how are currencies of the latter type valued in terms of one another? The answer is that an inconvertible-paper currency is valued in a free market like any other commodity: its worth is determined by the interaction of supply and demand. Thus, *the rate of exchange of an inconvertible-paper currency is determined by the supply of and the demand for it in foreign money markets.* If the demand for a currency increases (relative to another currency), its price in terms of the other currency (i.e., its rate of exchange) tends to rise; if its supply increases, or if the demand for it decreases, its price (rate of exchange) tends to decline. The rates at which inconvertible-paper currencies exchange for one another are free to move up or down *without limit* in response to the dictates of supply and demand. There is neither an upper limit nor a lower limit (except zero) to this fluctuation, quite unlike the situation under the gold standard where the gold points serve to positively limit fluctuations.

We may illustrate these basic principles, again using the relationship between the United States dollar and the British pound sterling as the case in point. In New York, exchange dealers stand ready to sell sterling for dollars and to buy sterling with dollars. The exchange rate between dollars and sterling which comes to prevail in the New York market is that dollar price for sterling which serves to equate the supply of and the demand for sterling. Similarly, in London, dealers stand ready to sell dollars for sterling and to buy dollars with sterling. The exchange rate between sterling and dollars which comes to prevail in the London

market is that sterling price for dollars which serves to equate the supply of and the demand for dollars. In a free market, the dollar price of sterling is free to move up or down without limit, as is the sterling price of dollars. The only qualification is that the dollar price of sterling in New York, whatever its level, must be the reciprocal of the sterling price of dollars in London. Thus, when £1=$2.80 in New York, $1.00=£0.357 in London.

Why the dollar price of sterling must be the reciprocal of the sterling price of dollars may be shown through examination of what tends to occur if the sterling price of dollars is at another figure, say £0.40, while the dollar price of sterling remains at $2.80. Under these circumstances, *arbitrage* tends to occur, i.e., dealers (and others) sell dollars for sterling in London, resell the sterling so obtained for dollars in New York, realizing a profit in the process, purchase more sterling in London with the proceeds, and so on. In the example cited, $1.00 obtains £0.40 in London, but £0.40 obtains more than $1.00 in New York ($1.00=£0.357, therefore £0.40 =$1.12). Thus, a movement from dollars to sterling takes place, and this movement continues until no further profit remains to be made by arbitrageurs. The adjustment process entails a shift in the sterling price of dollars from £0.40 (the reciprocal of which is $2.50) toward £0.357, or a shift in the dollar price of sterling from $2.80 toward $2.50 (the reciprocal of which is £0.40), or a little of both, until reciprocal rates again prevail. In short, the New York foreign-exchange market and the London foreign-exchange market are both part of the same market, and there thus tends to be price uniformity between them.

The essential feature of exchange rates under inconvertible paper is that they are free to fluctuate widely (if free-market conditions exist) in response to changes in overall supply-and-demand conditions as the latter relate to foreign exchange. Such fluctuations are of great importance because the particular exchange rate which happens to prevail in large part determines the prices of goods and services traded internationally. Thus, a change in the sterling-dollar rate from, say, £1=$4.03 to £1=$2.80 directly affects import and export prices in both the United States and Great Britain.[2] In this example, a British importer who obtained $4.03 for £1 under the old exchange rate receives but $2.80 for the same £1 under the new exchange rate. The shift from an exchange rate of £1= $4.03 to one of £1=$2.80 thus means a *depreciation* of sterling in terms of the dollar, or an *appreciation* of the dollar relative to sterling. The immediate effect upon international prices of a depreciation of sterling (or of an

[2] Such a change in the sterling-dollar rate occurred in September, 1949, although not as a result of free-market forces.

appreciation of the dollar) is to make exports from the dollar area more costly in terms of sterling, and to make the exports of the sterling area less expensive in terms of dollars. An appreciation of sterling (or a depreciation of the dollar) produces opposite effects.

The Purchasing-Power-Parity Concept

The purchasing-power-parity concept[3] is helpful in explaining how inconvertible-paper currencies are valued in terms of one another. By way of introduction, the basic logic behind the concept is as follows: First, viewed from a domestic standpoint, an inconvertible-paper currency has no intrinsic worth; its worth rests solely upon its capacity to command goods and services in exchange. The greater a currency's purchasing power, the greater is its worth, and vice versa. Second, viewed from an international standpoint, if the domestic worth of each currency is determined by its purchasing power in the home market, then the exchange rates which link the various currencies must of necessity reflect differences in the internal price levels (which affect the purchasing powers of the currencies) of the respective countries within which the currencies circulate.

From the foregoing it follows that if, at an existing exchange rate between two countries, it is cheaper for a person in one country to buy the currency of the foreign country in order to pay for imports than it is to use the equivalent value in domestic currency to purchase similar goods and services in the home market, then the domestic currency of this country is relatively overvalued (and the currency of the foreign country, where the situation is reversed, is relatively undervalued). In the country whose currency is relatively overvalued, exports tend to decrease relative to imports (because the country's exports are then relatively costly to foreign buyers, and imports are relatively cheap); in the country whose currency is relatively undervalued, exports tend to increase relative to imports. These developments, in turn, cause the demand for foreign exchange (relative to supply) to decrease in the country whose currency is relatively undervalued and to increase in the country whose currency is relatively overvalued. The interplay of supply-and-demand forces in the foreign-exchange markets of the two countries tends to bring about a shift in the value of each currency in terms of the other, i.e., an alteration in the exchange rate which links them. The rate of exchange between two currencies is likely to remain stable only when it is at a level which gives

[3] The purchasing-power-parity concept, first developed in the early nineteenth century by a group of English writers, was popularized in this century by Gustav Cassel, a Swedish economist.

each of the currencies identical purchasing power within each of the respective countries. This does not mean that the respective internal price levels, or cost levels, must be identical. The purchasing-power-parity concept simply suggests that, whatever the levels of domestic price within the respective countries, the rate of exchange between currencies tends to seek that point which eliminates price differentials between identical goods and services, as seen by the ultimate buyers and sellers in each of the countries. It is to be recalled here that the domestic price of imports is a combination of their price in terms of foreign currency *and* the domestic price of the foreign currency.

Carried one step further, this may be interpreted to mean that the exchange rate between, say, dollars and sterling must be equal to the ratio between the dollar outlay required to purchase a given stock of goods and services in the United States and the sterling outlay required to purchase the same array of goods and services in Great Britain. Thus, if a given quantity of wheat, steel, textiles, automobiles, etc., costs $4 million in the United States and £1 million in Great Britain, the exchange rate between dollars and sterling is £1=$4.00. This exchange rate expresses purchasing power parity since, under it, $1.00 (or £1) possesses identical purchasing power within either country when spent for identical goods and services.

The foregoing version of the concept, usually referred to as its *absolute purchasing-power-parity* version, has been criticized on a number of counts, three of which appear especially noteworthy. First, not all the goods and services of a country are in direct competition with similar goods and services in other countries. Some goods and services simply cannot be shifted from a lower-priced market to a higher-priced market, and hence there is no way to achieve price parity between them. Examples include housing and some perishable products. Second, even if items are readily shifted, the existence of transport costs and customs duties serves to create price differences between countries on identical items. Third, some persons are prone to argue that there is a tendency for internationally traded items to sell at a discount in the country in which they originate (where they presumably are in relative abundance) and at a premium in the country to which they move (where they presumably are relatively scarce).

In order to overcome these and other criticisms, the concept has been restated in a milder form, generally referred to as its *comparative purchasing-power-parity* version. This version does not regard the exchange rate as being equal to the ratio of total outlays for an identical array of goods and services purchased in two countries, but holds instead that

changes in relative purchasing power come to be reflected in changes in the exchange rate. For example, if in a given base period the equilibrium rate of exchange between the United States dollar and the Mexican peso was \$1=5 pesos, and if during a succeeding interval the United States price level doubled and the Mexican price level increased four-fold, then the new equilibrium rate of exchange should be \$1=10 pesos. In other words, if the price level of Mexico rises twice as rapidly as that of the United States, the purchasing power of the peso deteriorates twice as rapidly as that of the dollar, and hence the dollar worth of the peso ends up at but one-half its former level.

Although the comparative version of the purchasing-power-parity concept is less open to criticism than is the absolute version, it is nevertheless far from free of flaws. First, a common objection is that the concept in its comparative form does not readily lend itself to practical use in a statistical sense. For instance, it is difficult to recognize an equilibrium rate of exchange, and therefore difficult to select an appropriate base period from which to reckon changes in the exchange rate. Also, there is a legitimate question as to which price index most adequately reflects changes within each economy. Economists have suggested the use of wholesale price indices, retail price indices, indices of cost of living, indices of cost of production, etc. The choice made is a matter of considerable importance since the several price indices change at different times and in different amounts in response to particular pressures from within the economy. Moreover, most price indices appear inappropriate since they cover many domestic goods and services which never enter the international market. In rebuttal, it can be argued that the purchasing-power-parity concept is just that — a "concept" — and therefore its merit is not strictly measurable in terms of its statistical applicability. Second, and by all odds more important, the purchasing-power-parity concept, even in its comparative form, overlooks the basic fact that foreign exchange is desired, not merely to pay for imports of goods and services, but also to transfer income on investments and to undertake new foreign investments, both long-term and short-term. The exchange rate results from the interaction of the *total* supply of and demand for foreign exchange, not from just the interaction of supply and demand as the latter relate to the purchase and sale of goods and services alone (which are the items affected by price levels). There is no denying this fact, and so far the proponents of the purchasing-power-parity concept have grappled unsuccessfully with the problem posed.

Even though the purchasing-power-parity concept has its weaknesses, it is not entirely without use. The notion of a relationship between price

levels and exchange rates which it expresses is in itself a noteworthy contribution. Moreover, under special circumstances, such as at the close of a war during the course of which trade has been disrupted and individual countries have experienced varying amounts of inflation, the concept may have a practical value in enabling one to arrive at a first approximation of the exchange rates likely to reflect the new environment.

Exchange Stabilization

The replacement of a fixed exchange rate under the gold standard by a fluctuating exchange rate under an inconvertible-paper currency was favorably regarded by many persons, but all was not pure gain. For one thing, the complexity of doing business was increased as traders found it necessary to concern themselves with the problems associated with a fluctuating rate of exchange. Fluctuations due to seasonal factors were largely predictable, but such was not true of those fluctuations attributable to sudden shifts in international demand or to erratic shifts of capital, especially of short-term capital. Theoretically, traders were able to protect themselves against possible adverse movements in the exchange rate through the purchase or sale of forward exchange[4] (analogous to "futures" transactions in the domestic market), but often as not they were prone to view exchange instability as simply an additional risk in conducting business. Certainly the problems of the long-term foreign investor tended to be compounded.

For the above reason, and others, governments were inclined to explore the possibilities of intervention in the exchange market in order to control the rate of exchange.[5] One form of intervention was found in the exchange-stabilization funds, a number of which were established during the 1930's.[6] By 1939 and the outbreak of World War II, the treasuries or

[4] For an excellent discussion of *forward exchange*, see F. A. Southard, *Foreign Exchange Practice and Policy* (New York: McGraw-Hill Book Company, Inc., 1940), pp. 96-105.

[5] The idea of intervention in the foreign-exchange market was not new, a precedent of sorts having been set under the gold standard. The price at which a central bank or treasury bought and sold gold served to determine the international value of domestic currency, e.g., an increase in the price of gold was tantamount to a depreciation of the exchange rate.

[6] A few examples may be cited. In 1932, the British Exchange Equalization Account was established, chronologically the first exchange-stabilization fund. In 1934, the United States established a similar stabilization fund as an adjunct of the Treasury, financing it with \$1.8 billion of the \$2.8 billion in "paper profits" realized by the Treasury upon its gold holdings when the price of gold was raised from \$21.67 to \$35.00 per oz. In 1936, the United States, Great Britain, and France entered the Tripartite Monetary Agreement, under terms of which the participants agreed to cooperate in holding their exchange rates at or near existing levels, and later these countries were also joined by Belgium, the Netherlands, and Switzerland.

central banks of all the major countries were practicing stabilization in some form. The initial objective of the stabilization funds usually was to smooth out short-run fluctuations in exchange rates. It has been maintained (but never conclusively proven), however, that some countries, in practice, eventually sought to use their exchange-stabilization funds for the more ambitious purpose of promoting a favored exchange rate for their respective currencies (generally an undervalued rate during the depression years of the thirties, i.e., a rate which would give relative trading advantages vis-à-vis other countries).

The idea behind an exchange-stabilization fund is essentially that of allowing some central authority, generally the treasury or central bank, to act as an independent trader in the foreign-exchange market. The central authority does not arbitrarily "fix" the rate of exchange by decree; rather, it on occasion steps into the market as a buyer or seller of foreign exchange in order to affect the supply and demand schedules, and hence the rate of exchange ultimately determined by the interaction of supply and demand. The central authority sells domestic currency for foreign currency in order to prevent an appreciation of domestic currency (i.e., by offering domestic currency in exchange for a given amount of foreign currency, the price of the domestic currency is prevented from rising relative to foreign currency), or it buys domestic currency with foreign currency in order to prevent a depreciation of domestic currency (i.e., by offering foreign currency in exchange for a given amount of domestic currency, the price of the foreign currency is prevented from rising relative to the domestic currency). In short, a stabilization fund consists of a pool of currencies to which the central authority adds, or from which it subtracts, as conditions warrant. Just as a reservoir acts to stabilize the flow of water, so stabilization fund authorities can act to stabilize the international value of a currency.

The success of a stabilization fund depends in large degree upon its resources, especially if large-scale or prolonged operations prove necessary. No particular problem is involved in preventing the appreciation of a domestic currency since the central authority can always acquire more domestic currency to offer in the foreign-exchange market. In the final analysis, it is always possible (theoretically) for a country to print more of its own currency. A country cannot print foreign currency, however, and for this reason the successful operation of a stabilization fund requires that it possess enough foreign currency (and gold, which enables it to acquire more foreign exchange) to permit it to prevent the depreciation of its own currency under any likely conditions. Since an exchange-stabilization fund of necessity is confronted with an absolute limit in the supply of

foreign exchange which it may sell to support the value of domestic currency, it follows that the exchange-stabilization procedure holds more promise in preventing currency appreciation than in preventing currency depreciation.

EXCHANGE CONTROL

While an exchange-stabilization fund may assist greatly in toning down minor fluctuations in the exchange rate, it leaves much to be desired when pressure upon the exchange rate is intense. This is especially true when the resources of the stabilization fund are inadequate to allow foreign exchange to be recouped at a pace sufficiently rapid to deter a depreciation of domestic currency beyond desired levels. A stronger form of intervention in the foreign-exchange market is found in exchange control. *Exchange control is a technique for the mobilization and subsequent allocation of relatively scarce supplies of foreign exchange; its usual objective is that of forcibly confining the demand for foreign exchange within limits of the available supply of foreign exchange, thereby allowing the rate of exchange to remain stable, even though this rate may be at an overvalued level.* Under exchange control, the rate of exchange does not, strictly speaking, arise from the interaction of supply-and-demand forces in the foreign-exchange market; rather, the effective demand for foreign exchange is tailored to fit the supply of foreign exchange available, given a particular rate of exchange.

Far from unknown during the 1930's, exchange control in some form came to exist in well over one-half the countries of the world during the first decade following World War II. In a number of instances, exchange control simply evolved from exchange-stabilization funds already in existence. As a technique, however, it differs from the latter in both principle and degree. While the authorities who manage an exchange-stabilization fund on occasion enter the foreign-exchange market as traders, buying and selling *in competition* with other and individually smaller traders, under exchange control (in its ultimate form) the treasury, central bank, or special control agency becomes the *sole* buyer and seller of all foreign exchange. Under exchange stabilization the government competes with private traders in the same market, but under exchange control (in its ultimate form) private traders are obliged to buy or sell all foreign exchange through a government market and under prescribed conditions. Exchange control involves compulsion, but exchange stabilization does not.

A fundamental attribute of exchange control in its ultimate form, then, is the monopsonistic-monopolistic activity of the control authority. Residents coming into possession of foreign exchange are required to relin-

quish it to the control authority in exchange for domestic currency, and at a price (exchange rate) set by the control authority. Similarly, residents desiring foreign exchange may purchase it only from the control authority, and only under such conditions and at such rates of exchange as may be designated. Since competitive forces no longer prevail in the foreign-exchange market, the control authority is able to discriminate at will. Foreign exchange may be purchased at one rate and sold at another and higher rate, or both purchases and sales may occur at a variety of rates. In fact, *multiple exchange rates* are common under exchange control, generally arising as a means to extend preferred treatment to particular export industries, or as a means to discourage particular demands for foreign exchange. Apart from discriminatory treatment in the price at which exchange is purchased and sold, the control authority may discriminate between persons and uses by alternately allowing or disallowing the purchase of foreign exchange by local residents. Thus, foreign exchange may be made available for particular types of foreign purchases, but not for others. Again, foreign exchange may be made available for purchases in particular countries, but not in other countries. Finally, the conditions under which foreign exchange is made available may be varied from time to time, depending upon the control authority's appraisal of what appears to be warranted. The procedure which is actually followed varies widely from country to country, being far more stringent in some countries than in others.

In summary, while exchange control may serve various purposes (discussed in detail in a subsequent chapter), its most basic purpose is to limit the demand for foreign exchange so that it cannot exceed the supply becoming available, and in this manner to enable the established exchange rate to be maintained. If, for example, the free interaction of supply and demand is likely to result in depreciation, the control authorities may maintain the official value of a country's currency at an overvalued rate simply by rationing the available supply of foreign exchange among those wishing to purchase it.

Exchange-Rate Compatibility

As we have seen, there is an exchange rate to link each pair of currencies. Under free-market conditions, the various exchange rates tend to be compatible, one with the other. Thus, the exchange rates which link the United States, Great Britain, and France tend to be such that an exchange of dollars for sterling, sterling for francs, and francs for dollars yields the same amount of dollars as existed at the outset. The arbitrage transactions of traders, as we observed earlier, tend to assure such compat-

ibility whenever there is a free market in foreign exchange, whether it be under conditions of a gold standard or of inconvertible paper.

Under exchange control, in contrast, there is no similar assurance of exchange-rate compatibility. This is so because there no longer is a free exchange market within which arbitrageurs may act to bring about this result. Under exchange control, foreign exchange is mobilized and rationed by a central authority; free convertibility of currencies no longer exists. In the case of three countries (say, the United States, Great Britain, and France), there are three foreign-exchange markets, each one separate and distinct from the others. There is thus no reason to expect the resulting exchange rates (e.g., the dollar-sterling rate, the sterling-franc rate, and the franc-dollar rate) to be compatible. When such rates are incompatible, we refer to the situation as one of *disorderly cross rates.* For example, when \$1.00=£0.357, £1=1,000 francs, and \$1.00=340 francs, disorderly cross rates exist; \$1.00 is then worth £0.357, but £0.357 is worth 357 francs, which are worth \$1.05.

SUMMARY

Foreign exchange consists of all those credit instruments which give residents of one country a claim upon money, or purchasing power, in another country. Foreign exchange is bought and sold through the foreign-exchange market, the effect of which transactions is to transfer purchasing power between countries.

The price at which one currency exchanges for another in the foreign-exchange market is known as the rate of exchange. Three distinct sets of market conditions surround the determination of the rate of exchange:

(1) Under the gold standard, the rate of exchange is "fixed" at mint parity and is free to fluctuate only moderately within limits set by the gold points.

(2) Under an inconvertible-paper currency, the rate of exchange is free to fluctuate without limit in response to the forces of supply and demand.

(3) Under exchange control, a government attempts to maintain a desired exchange rate for its currency, frequently an overvalued rate, by rationing the available foreign exchange among various demanders on the basis of some arbitrary standards devised for the purpose.

SELECTED REFERENCES

Brown, W. A., Jr., *The International Gold Standard Reinterpreted, 1914-1934.* New York: National Bureau of Economic Research, 1940, 2 vols.

Cassel, G., *Money and Foreign Exchange after 1914.* London: Constable & Company, Ltd., 1922, Chaps. V-VI, X-XI.

°Crump, N., *The ABC of the Foreign Exchanges,* 11th ed. London: Macmillan & Co., Ltd., 1951, Chaps. IX-XIII, XX-XXI.

°Halm, G. N., *Monetary Theory.* Philadelphia: The Blakiston Company, 1946, Chaps. 11-14.

Hawtrey, R. G., *The Gold Standard in Theory and Practice,* 5th ed. London: Longmans, Green & Company, 1947.

International Monetary Fund, *First Annual Report on Exchange Restrictions,* Washington, 1950. (Also see subsequent annual reports.)

°Machlup, F., "The Theory of Foreign Exchanges," reprinted in American Economic Association (ed.), *Readings in the Theory of International Trade.* Philadelphia: The Blakiston Company, 1949.

°Robinson, J., "The Foreign Exchanges," reprinted in American Economic Association (ed.), *Readings in the Theory of International Trade.* Philadelphia: The Blakiston Company, 1949.

°Southard, F. A., *Foreign Exchange Practice and Policy.* New York: McGraw-Hill Book Company, Inc., 1940, Chaps. II-III.

5

Balance-of-Payments Adjustments

IN THE PRECEDING chapter we saw that the rate of exchange is a price determined by the interaction of the supply of and demand for foreign exchange. We intimated also that the rate of exchange is a factor which affects the supply of and demand for foreign exchange. The rate of exchange is then both an *effect* and a *cause*. In this chapter, we turn to an examination of how the supply of and demand for foreign exchange themselves vary, and how, through the mutual interdependence of the rate of exchange and the supply of and demand for foreign exchange, adjustments are brought about in the balance of payments when either deficits or surpluses arise.

BALANCE-OF-PAYMENTS DISEQUILIBRIUM

The foreign exchange acquired by a country through exports of goods and services and through autonomous capital imports provides it with the means to finance its imports of goods and services and its autonomous capital exports. If the current rate at which supplies of foreign exchange accrue is inadequate to meet current needs, so that the particular country is compelled on that account to draw upon its reserves of foreign exchange and gold, to reduce its foreign assets, or to increase its foreign liabilities, the country's balance of payments is said to show a deficit, i.e., its balance

of payments is not in equilibrium. If the current level of payments-receipts exceeds that of payments-obligations, on the other hand, the balance of payments is said to show a surplus; again there is an absence of equilibrium.

A deficit or a surplus in the balance of payments of a country is not an uncommon occurrence. The reason for imbalance goes far deeper than the fact that, under free-market conditions, the total autonomous credit and debit transactions of a country can hardly be expected to be in exact balance from day to day or week to week. A pronounced deficit of relatively extended duration commonly arises, for example, when a crop failure reduces export capacity, when the development abroad of synthetics or rival products reduces the demand for exports, when widespread depression abroad adversely affects exports, when an increase in domestic price more rapid than increases abroad serves to discourage exports and to encourage imports, etc. On the other hand, a surplus may arise because of a shift of world demand in favor of a particular country's products, because of relatively low prices in the domestic market, or for other reasons.

When the delicate balance in a country's balance of payments is disturbed, how is equilibrium restored? International-trade theorists have concerned themselves with this question over the years, and a considerable body of literature has been built up on the subject. Summarizing this literature, the following points appear basic. *Under free-market conditions (either under the gold standard or under inconvertible paper), adjustments in the balance of payments occur automatically through changes in* (a) *exchange rates,* (b) *prices, and* (c) *incomes.* In contrast, *a country which is unwilling to submit to adjustment under free-market conditions may, in event of a deficit, undertake to secure balance in its international accounts through the imposition of exchange control, the purpose of which is to forcibly restrict the current demand for foreign exchange to an amount no greater than the supply becoming available.*

The following pages are devoted to the matter of adjustment in the balance of payments. For simplicity of presentation, the analysis is arranged under three major headings: (1) adjustment under conditions of the gold standard, (2) adjustment under inconvertible-paper currencies, and (3) adjustment under systems of exchange control.

BALANCE-OF-PAYMENTS ADJUSTMENTS UNDER CONDITIONS OF THE GOLD STANDARD

As we have seen, the exchange rate under the gold standard is "fixed," being free to fluctuate only within narrow limits set by the gold points.

Since the gold flows which occur at the gold points serve to remove pressure from the exchange market in an immediate sense, they offer a satisfactory explanation of *short-run* exchange-rate stability under the gold standard. The foregoing, however, cannot also suffice as an explanation of *long-run* exchange-rate stability. The flow of gold from a country cannot be continued indefinitely, for a country's gold stocks are not unlimited. Clearly, a satisfactory explanation of long-run exchange-rate stability under the gold standard must rest upon factors in addition to the mere short-run outflow or inflow of gold.

Two basic lines of approach have been developed in an attempt to explain the phenomenon of how a relatively stable exchange rate under the gold standard is consistent with long-run, balance-of-payments equilibrium. The first of these, originating with the "classical" school of economists (David Hume, Adam Smith, John Stuart Mill, Alfred Marshall, and others, writing in the period covering roughly 1750 to 1914), emphasizes changes in the *price* levels of the various economies as the force which serves to maintain or restore equilibrium in the balance of payments. This explanation is stated in terms of certain automatic correctives associated with the so-called "price-specie-flow mechanism." A second, and more recent, explanation emphasizes changes in *income* within the various economies, and employs a concept known as the "foreign-trade-income multiplier." Proponents of the latter point of view by no means deny the equilibrating effects of price changes, but they do stress that income changes are relatively more significant.

By way of introduction, it suffices here to say that such changes, whether occurring through price or income or through a combination of the two, serve to alter fundamentally the environment which conditions the supply of and demand for foreign exchange. The effect of these changes, in tending to equilibrate the supply of and demand for foreign exchange at a fixed rate of exchange, is to promote long-run equilibrium in the balance of payments. A closer examination of the two basic points of emphasis may serve to indicate in more precise fashion how it is that long-run equilibrium is fostered.

Price-Specie-Flow Mechanism

The manner in which the operation of the price-specie-flow mechanism promotes equilibrium in the balances of payments of trading countries may be illustrated through use of an example (Fig. 4). For simplicity we may assume only two trading countries, A and B, each of whose balance of payments we may assume to be in equilibrium at the outset. We may further assume that the price level in each country is at the level

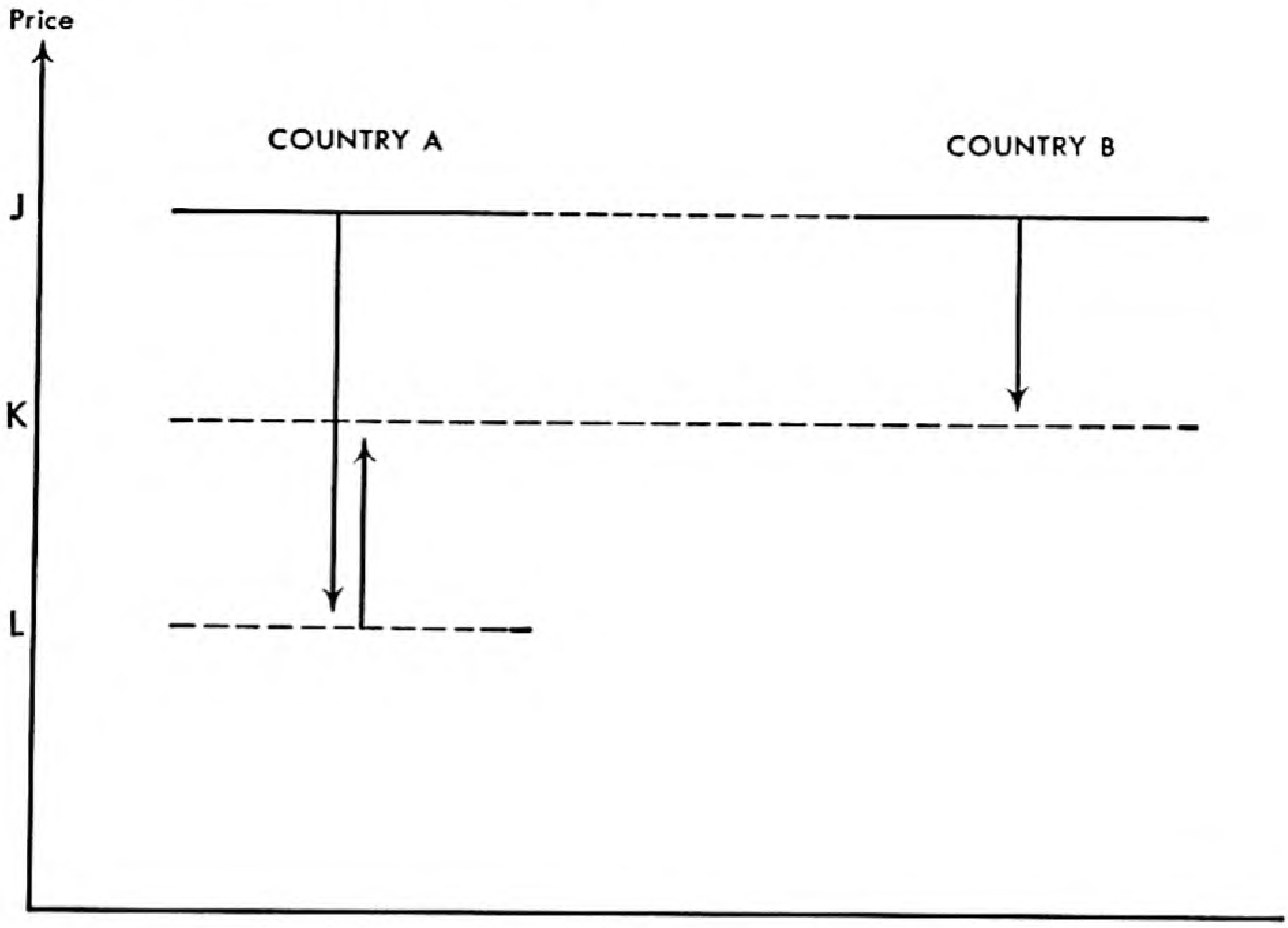


Figure 4
International Price Adjustments under the Gold Standard

shown by *J*. (Such equilibrium need not imply that the domestic price levels of the two countries are identical. The condition of equilibrium merely implies that the prevailing price levels allow a flow of trade such that there is a rough equivalence in the supply of and demand for foreign exchange within each country.)

We may ask what is likely to occur within each of the countries if the initial equilibrium is for some reason disturbed. Let us assume, for example, that for purely domestic reasons A begins to experience a serious deflation and that its price level begins to decline (from *J* toward *L*). According to proponents of the gold standard, certain automatic correctives are soon drawn into play. At the outset, the relatively lower price level in A serves to alter trading relationships between A and B. Within A, lower prices tend to boost exports as residents of B find A a cheaper place in which to buy. Also, lower prices in A tend to reduce that country's imports from B as domestic consumers shift from relatively costly imports to relatively cheaper domestic goods. The net effect upon A is to increase the supply of foreign exchange accruing to it and to decrease the demand for this foreign exchange. Within B, the situation tends to be opposite in character. In consequence of these developments, the exchange rate in A tends to move in the direction of the gold import point

(and, in B, the exchange rate tends to move in the direction of the gold export point), at which point gold begins to flow from B to A. In short, a net export surplus (computed on the basis of all autonomous transactions) is paralleled, or offset (entirely, or in part), by a net inflow of gold; conversely, a net import surplus is offset (entirely, or in part) by a net outflow of gold. The foregoing analysis provides the basis for the contention that *the flow of gold between countries promotes short-run, balance-of-payments equilibrium (and short-run, exchange-rate stability within limits set by the gold points) under the gold standard.*

One important qualification must be interjected. The flow of gold between countries in response to deficit-surplus situations is delayed somewhat, or minimized, by virtue of the movement of short-term capital. Such a movement occurs because of changes in (1) exchange rates and (2) interest rates. When the exchange rate in B, returning to our example, begins to move in the direction of the gold export point, exchange dealers in that country may draw down their foreign balances to a level lower than usual in order to take advantage of higher than usual exchange rates in the domestic market. Such a short-term capital inflow in B adds to the supply of foreign exchange currently available for sale to potential demanders, and it therefore helps prevent the exchange rate from moving to the level of the gold export point. Similarly, when the exchange rate in A begins to move in the direction of the gold import point, exchange dealers in that country may choose to add to their foreign balances, since foreign exchange is then obtainable at what appears to be bargain prices. Their demand for foreign exchange, in reality a short-term capital outflow for A, helps retard a shift in the exchange rate to the level of the gold import point. In short, the movement of short-term capital (an inflow in B and an outflow in A) serves as a substitute for the movement of gold in stabilizing the rate of exchange.

Second, short-term capital movements are induced by changes in interest rates; a higher rate of interest (relative to rates prevailing abroad) tends to encourage an inflow of capital, while a lower rate of interest (relative to rates prevailing abroad) tends to encourage an outflow of capital. A significant fact in this connection is that the rate of interest is affected by relative changes in the supply of and demand for foreign exchange. When an exporter sells foreign exchange to his bank, the bank's foreign balances are increased, but so also are domestic demand deposits and the country's monetary supplies; the purchase of foreign exchange by an importer has effects opposite in character. A crucial point is that the receipt of foreign exchange serves to increase a country's money supply, while the use of foreign exchange serves to decrease a country's money

supply. A second crucial point is that an increase in the money supply (all other things being equal) tends to lower the rate of interest, while a decrease in the money supply (all other things being equal) tends to raise the rate of interest. In short, when a country's supply of foreign exchange increases (relative to demand), its money supply expands, and this situation (all other things being equal) leads to a lower rate of interest; when a country's supply of foreign exchange decreases (relative to demand), its money supply contracts, and this situation (all other things being equal) leads to a higher rate of interest. Applying the foregoing to our example, when A's supply of foreign exchange increases (relative to demand), its money supply is increased, and its rate of interest tends to fall; at the same time, the diminished supply of foreign exchange (relative to demand) in B leads to a decrease in its money supply, and to an increase in its rate of interest. The increase in the rate of interest in B (relative to A) tends to induce short-term capital to move from A to B. To the extent that such a movement occurs, the flow of gold becomes unnecessary.

In the short run, then, balance-of-payments equilibrium under gold-standard conditions results from the inter-country flow of gold, except in so far as the latter is made unnecessary by the movement of short-term capital. *Long-run equilibrium in the balance of payments is dependent upon certain additional developments, namely, price changes and income changes.* The first pertinent factor is that the movement of gold, which eventually occurs between countries when disequilibrium is large-scale or persistent, affects the money supplies of the countries concerned, and hence their price levels. For example, a loss of gold by B serves to reduce that country's money supply (since it is a condition of the gold standard that the treasury or banking system will take steps to maintain the supply of money at some ratio to the supply of gold). A decrease in the supply of money (all other things being equal) leads to a decrease in B's domestic prices (from *J* toward *K*), according to the quantity theory of money, an essential element in the price-specie-flow line of reasoning. Developments opposite in character occur in A. The balance-of-payments surplus of the latter induces gold inflows, the monetization of which (all other things being equal) tends to halt the price decline (or, reverses the direction of prices from *L* toward *K*). The decline in prices in B, accompanied by no further price decreases in A, serves to increase B's exports relative to her imports and to decrease A's exports relative to her imports. In other words, the demand for foreign exchange (relative to supply) increases in B and decreases in A. At some point, shown in Fig. 4 by the broken line at *K*, the balance of payments of each of the countries is again

in equilibrium, i.e., in each of them the demand for foreign exchange and the supply of foreign exchange are roughly equal.

Summarizing, a trade imbalance arising under the gold standard in due course gives rise to a movement of gold (if the imbalance is large-scale or persistent). This movement, according to the foregoing theory, has the effect of altering the money supply and the price level of each of the countries concerned. In consequence of shifts in prices, trade undergoes a change in volume and direction. Balance-of-payments equilibrium is restored when the new trading relationships result in a rough equivalence between the demand for and the supply of foreign exchange. Significantly, equilibrium is restored primarily through adjustments in price (and in the volume and direction of trade), the adjustment in the exchange rate being limited to the range of the gold points. (It is interesting to note that factors of a purely domestic nature within A — in our example — may serve to bring about profound repercussions within B, and that equilibrium is restored through having B meet A halfway, so to speak. More will be said at a later point concerning the implications of a process which promotes equilibrium in the balance of payments in this manner.)

Two major criticisms have been made of the type of analysis which is based on the price-specie-flow mechanism. The first of these criticisms states that the automatic correctives of the gold standard may work successfully *if* given free reign, but that in practice this really doesn't mean much since national authorities are prone for various reasons to intervene in ways which obstruct the equilibrating forces from functioning freely. The theory of the gold standard holds that if balance-of-payments disequilibria are to be remedied in automatic and smooth fashion through operation of the price-specie-flow mechanism, certain "rules of the game" have to be observed. A fundamental rule is that each country must permit its money supply to increase with gold inflows and to decrease with gold outflows, and that it must take no deliberate action to obstruct these flows of gold. If this rule is observed, changes can occur in internal prices and can, in turn, serve to eliminate the balance-of-payments disequilibria which may arise.

Historically, however, the freedom of gold movements and the adjustment process were repeatedly interfered with through governmental action. Governments came to think of themselves as the guardians of a high and stable level of income and employment in the domestic economy. Accordingly, they on occasion introduced monetary and fiscal measures intended to promote this end. The conflict between the rules of the game of the gold standard and the pursuit of independent domestic

policies, however, was clear-cut: on the one hand, the rules of the game prescribed free adjustment within each country to changing international conditions; on the other hand, governments sought to insulate their domestic economies against repercussions arising from the international economy.

The above conflict arose, basically, from a difference in objectives: under the gold standard, the attainment of international equilibrium (i.e., balance-of-payments equilibrium in each country vis-à-vis the rest of the world) through the operation of free-market forces was pictured as the objective of paramount importance, and it was expected that each country would pursue a course in its domestic affairs compatible with the attainment of this objective; but many governments, inclined to view domestic prosperity as a necessary condition, proceeded on the assumption that the latter was more certain to result from the inauguration of deliberate domestic measures than from the operation of free-market forces. Perhaps then, as some economists have suggested, the gold standard broke down, not because it didn't (or couldn't) work, but because it wasn't permitted to do so. And, perhaps, the gold standard wasn't permitted to function freely because the likely consequences of its operation were widely feared!

Adjustment Through Income Changes

A second criticism of the price-specie-flow mechanism rests on the grounds that it attempts to explain the process of adjustment in the balance of payments in terms of price changes and, in so doing, entirely neglects the role played by income changes. Economists in recent years, especially since the period of the Great Depression, have been instrumental in pointing out that exports and imports have important effects upon national income, and that these changes in national income are largely responsible for the adjustments which do occur in the balance of payments. Though generally used in an analysis of non-gold-standard situations, the newer approach serves also to point up weaknesses in the arguments previously advanced in the case of the gold standard. The basic idea of this newer approach is generally presented in terms of the foreign-trade-income multiplier, an extension of the simple domestic investment multiplier.

The multiplier principle, applied to the domestic economy, states that an initial (additional) investment expenditure may induce a series of secondary income effects such that the total income effect within the economy is a multiple of the initial expenditure.[1] Thus, when an initial

[1] Conversely, a fall in investment may induce a multiple contraction of income.

(additional) investment expenditure of \$1.00 occurs, this amount represents income to the person (or persons) receiving it, whereupon the recipient is free to decide what portion of this income is to be spent on consumption and what portion is to be saved or otherwise drawn off. If we assume the marginal propensity to consume (MPC) to be .5 (i.e., one-half of each additional increment of income received is spent), then 50¢ is spent and 50¢ represents a "leakage" from the income stream. The 50¢ spent, in turn, represents income to those receiving it, who then also must decide what portion of their newly acquired income is to be spent and what portion is to be saved, and so on at each succeeding stage. Assuming a constant MPC of .5, the successive amounts of income (Y) and saving (S) may be shown as follows:

$$Y = \$1.00 + .50 + .25 + .125 + .0625 + \ldots = \$2.00$$
$$S = \qquad .50 + .25 + .125 + .0625 + \ldots = \$1.00$$

In the example, an initial expenditure of \$1.00 produces a total income effect which approaches a limiting position of \$2.00. The multiplier is thus said to be 2. The reason the multiplier in the example is not higher is because of leakages (S) from the income stream. If there are no leakages, an initial investment of any amount produces an infinite amount of income. The multiplier is simply the reciprocal of the marginal propensity to save ($MPS = 1 - MPC$). If $MPS = \frac{1}{2}$, the multiplier is 2; if $MPS = \frac{1}{3}$, the multiplier is 3; or, in general terms, the multiplier is $\frac{1}{MPS}$. The multiplier continues to multiply, so to speak, until total leakages equal the initial injection of purchasing power. In the example, when total S equals \$1.00, the sequence of secondary income effects occasioned by the initial (additional) investment of \$1.00 has run its course. The essential conclusion for our purposes is that investment, in and of itself, creates income, whereas saving, in and of itself, constitutes a drain from the income stream which curbs the further generation of income.[2]

The foreign-trade multiplier is concerned with the effect upon a country's national income which results from changes in exports (or exports relative to imports) induced by income changes abroad. The mechanics of the foreign-trade multiplier is similar to the domestic multiplier; the basic difference is that exportation (instead of investment) is shown as the factor generating income and importation plus saving (instead of saving alone) are shown as being responsible for leakages from the income stream. The logic behind the foreign-trade multiplier is that an increase in exports puts additional income into the hands of exporters,

[2] Savings can, of course, subsequently be used (i.e., be spent). But the act of saving, taken by itself, involves a leakage from the income stream as indicated.

and this income is then either spent domestically (on wages, supplies, consumption, etc.), spent on imports, or saved. The portion spent domestically constitutes income for those receiving it and is, in turn, either spent or saved by the recipients, and so on through successive stages. At each stage, that portion of current income which is spent continues to generate national income.[3] It does so, however, only as long as this spending occurs against domestic goods and services. If some of the added income is spent on imports, the chain of domestic spending breaks down (assuming, of course, that the level of exports remains unchanged). We may conclude that exports generate income in the domestic economy, but that imports, in and of themselves, constitute a leakage from the income stream.[4]

It may also be shown that, in the absence of domestic saving, a given amount of additional exports serves to increase domestic income up to the point where the added income leads to additional imports equal to the initial exports, at which point the initial (additional) exports are matched by an equivalent value of induced imports. For example, assuming no domestic saving and a marginal propensity to import (MPM) of .5 (i.e., one-half of each additional increment of national income is spent for additional imports), an initial (additional) export of, say, \$1.00 yields the following secondary (or induced) increments of income (Y) and of imports (M):

$$\begin{aligned} Y &= \$1.00 + .50 + .25 + .125 + .0625 + \ldots . = \$2.00 \\ M &= \qquad\quad\; .50 + .25 + .125 + .0625 + \ldots . = \$1.00 \end{aligned}$$

In the example, an export of \$1.00 produces a total income effect which approaches a limit of \$2.00. The foreign-trade multiplier is thus said to be 2 (i.e., it is the reciprocal of the marginal propensity to import, $\frac{1}{MPM}$) .

In showing how changes in income may serve to equate imports and exports, the foreign-trade multiplier points up the manner in which income changes may bring about adjustments in the balance of payments. By way

[3] If the initial increase in exports occurs when the economy is at less than full employment, the increase in income is attributable primarily to added employment and output, first in the export industries directly concerned, and next in other industries as the latter come to benefit from the heightened prosperity of the former. If the increase in exports occurs under conditions of full employment, resources tend to be diverted toward particular export lines, creating domestic shortages and higher prices. A higher level of national income under these conditions is attributable primarily to higher prices. For a general discussion of the interrelationship of income, price, and employment (emphasis being upon the domestic economy), see T. Morgan, *Income and Employment*, 2d ed. (New York: Prentice-Hall, Inc., 1952), Chap. 5, see esp. Chart 7, p. 106.

[4] A decrease in imports (relative to exports) produces the identical effect via the multiplier as does an increase in exports (relative to imports).

of illustration, let us assume that for some reason (e.g., changes in production techniques, changes in tastes, or other similar reasons) equilibrium in the balance of payments of Country A is disturbed, the outward symptom being an increase in the country's exports such that its balance of payments shows a surplus. Because of the added exportation, the income of A increases. The new income may be spent for additional domestic goods and services, it may be spent for additional imports, or it may be saved. To the extent that the new income is spent for domestic goods and services, still more income is generated domestically. The higher level of income, however, also induces new and additional imports, the volume per increment of income depending upon the country's marginal propensity to import. Such imports constitute a leakage from the domestic income stream. We may thus conclude, assuming no domestic saving, that an increase in A's national income because of a temporary surplus in its balance of payments leads to an increase in its imports and, according to our analysis, such additional imports tend to occur in an amount equal to the surplus initially experienced in the balance of payments. At this point, equilibrium is re-established in the balance of payments of A (i.e., the supply of and the demand for foreign exchange are brought into rough equivalence at the prevailing exchange rate). Developments of an opposite character tend to occur as contraction takes place in the country (or countries) experiencing a temporary balance-of-payments deficit as a counterpart of A's balance-of-payments surplus.

The above adjustment process may appear flawless, but reality poses obstacles. For example, if some of the income which A derives from its additional exports is saved, rather than spent for domestic goods and services, the secondary increase in income is less, and the level of additional (induced) imports tends to prove insufficient to restore equilibrium in the balance of payments. Despite this important limitation, it is apparent that income changes are capable of playing a major role in the process of balance-of-payments adjustment, with or without the accompanying aid of price changes.

Finally, it is important also to recognize that any adjustments are dependent upon the willingness of the countries concerned to allow them to occur, and to refrain from the adoption of monetary and fiscal measures designed to nullify their effects. Some domestic actions, though perhaps justifiable on some grounds, may serve to initiate or intensify disequilibrium in a country's balance of payments, rather than to assist in the restoration of equilibrium.

BALANCE-OF-PAYMENTS ADJUSTMENTS UNDER INCONVERTIBLE-PAPER CURRENCIES

The international gold standard no longer exists, and with its demise the automatic adjustments inherent in the price-specie-flow mechanism also came to an end. It is important, therefore, to examine the process of balance-of-payments adjustment as it prevails under the systems of inconvertible paper which came to succeed the gold standard, beginning especially during the years of the Great Depression.

Under inconvertible paper, short-run equilibrium between the supply of and demand for foreign exchange is achieved through changes in the price of foreign exchange itself. Whenever, for example, the demand for foreign exchange exceeds the supply of foreign exchange at the existing rate of exchange, the price of foreign exchange rises, i.e., the domestic currency depreciates, and this depreciation proceeds until a new and greater supply of foreign exchange (on the same supply schedule) is forthcoming or a portion of the existing demand is curtailed. In contrast, whenever the supply of foreign exchange exceeds the demand for foreign exchange at the existing rate of exchange, the price of foreign exchange declines, i.e., the domestic currency appreciates, and this appreciation proceeds until the supply of and the demand for foreign exchange are again brought into rough equivalence. Unlike the situation under the gold standard, where the exchange rate is free to fluctuate only within limits of the gold points, under inconvertible paper the rate of exchange is free to fluctuate upward or downward *without limit.*

Such changes in the rate of exchange serve to equilibrate the supply of and demand for foreign exchange because they, in effect, serve to alter the prices of internationally traded goods, and hence the course of trade itself. By way of illustration, we may inquire what is likely to occur if pressure upon the exchange market alters the prevailing rate of exchange between, say, Great Britain and the United States from £1=$4.03 to £1 =$2.80.[5] The initial impact of such a change is to leave unaltered the domestic value of each currency within its home country, but to alter the value of each currency in terms of the other. The dollar is now more costly in terms of the pound sterling than previously or, conversely, the pound sterling is now cheaper in terms of dollars. In other words, the dollar has appreciated (in terms of pounds sterling) and the pound sterling has depreciated (in terms of dollars). An article priced at £1 within

[5] The example, previously cited (Chapter 4), depicts the historical situation prevailing before and after the British depreciation of the pound sterling in 1949. This depreciation, however, did not occur under free-market conditions.

Great Britain, which previously cost an American importer \$4.03 (assuming no transport costs or customs duties), is obtainable by the latter under the new exchange rate for \$2.80. The British exporter, however, may convert \$2.80 and still obtain the sum of £1. If the British exporter continues to sell the article in the United States for \$4.03, his proceeds in terms of sterling amount to approximately £1.44 under the new exchange rate. On the other hand, an American article priced at \$4.03, previously obtainable by a British importer for the sum of £1, costs £1.44 under the new exchange rate. The American exporter, however, must receive £1.44 for the article if he is to convert the sterling into \$4.03. If the American exporter continues to offer the article in the British market for £1, his proceeds, when converted to dollars under the new exchange rate, amount to only \$2.80 instead of the \$4.03 obtainable under the old exchange rate.

Clearly, the effect upon the United States of an appreciation of the dollar (a depreciation of the pound sterling) is to discourage its exports to and to encourage its imports from Great Britain (since dollars come to have increased purchasing power when used to acquire British goods, and pounds sterling come to have reduced purchasing power when used to acquire United States goods); conversely, a depreciation of the dollar (an appreciation of the pound sterling) tends to discourage British sales to the United States and to encourage British purchases from the United States (since dollars come to have reduced purchasing power when used to acquire British goods, and pounds sterling come to have increased purchasing power when used to acquire United States goods). The precise effect upon the volume and type of importation and exportation in each country depends in part upon the extent of the appreciation or depreciation, but also upon the elasticities of supply and demand of the internationally traded goods in question. In any event, as United States imports increase (relative to exports) following an appreciation of the dollar, this country's demand for foreign exchange (relative to supply) tends also to increase; similarly, as British exports increase (relative to imports) following a depreciation of the pound sterling, the demand within Britain for foreign exchange (relative to supply) tends to decrease. It is in this way that a change in the rate of exchange brings about an adjustment in the balance of payments. The adjustment process continues until there is a rough equivalence between the supply of and demand for foreign exchange within each country (at some rate of exchange which is compatible between them).

In summary, under inconvertible paper, shifts in the supply of and demand for foreign exchange bring about shifts in exchange rates, but the

latter, in turn, tend to bring about shifts in the supply of and demand for foreign exchange because of their effect upon the prices of internationally traded goods. In other words, *short-run adjustments in the balance of payments of a country under inconvertible paper tend to occur in response to changes in the exchange rate.*

The Role of Price and Income Changes

Alterations in the rate of exchange, especially when pronounced and persistent in a given direction, tend to produce additional (secondary) effects, relatively long-run in nature. These *long-run effects arise through changes in the domestic levels of price and income.*

The precise effect which an alteration in the rate of exchange tends to have upon the domestic price level depends on several factors, the most basic one being the degree of employment prevailing within the economy. If, for example, a depreciation occurs when the economy is at or near full employment, its initial effect is to raise prices. This is the case because of the relative shortage of goods which depreciation then tends to promote; depreciation tends to increase exports and to decrease imports, but full employment, by definition, leaves little scope for a prompt increase in domestic output. The increase in prices is not confined to internationally traded goods alone, but extends also to domestic goods which are competitive with imports, and to domestic goods which compete for the same resources drawn upon by producers of internationally traded goods. If, on the other hand, a depreciation occurs when the economy is at less than full employment, its initial effect is to increase output and employment as exports expand and imports decline. Only after much of the "slack" within the economy has been removed does there begin to be marked pressure upon prices.

In general terms, depreciation tends to initiate inflationary pressures within the economy. Conversely, appreciation tends to prove deflationary. Such price effects are significant in that they serve to evoke adjustments in the balance of payments. It may be argued, for example, that a pronounced inflation in one country (meaning a greater increase in its prices than what has occurred elsewhere) tends to prove self-correcting in the sense that the relatively high price level leads to a greater volume of imports, while it at the same time discourages exports; in contrast, deflationary conditions entail self-correcting consequences opposite in character. In either case, changes in domestic prices are followed by shifts in exports and imports, upon which balance-of-payments equilibrium, or the lack of it, is basically dependent.

In addition to the impact of price changes, changes in income are also

important in the process of balance-of-payments adjustment under inconvertible paper (just as in the case of the gold standard). According to the analysis of the foreign-trade multiplier, both the expansion in exports and the reduction in imports following depreciation serve to augment a country's national income. The higher level of income, in turn, has repercussions upon the balance of payments. Specifically, a higher level of income tends to curb exports (because domestic demand for home goods increases as income increases) and tends to expand imports (because the increase in domestic demand attracts foreign goods). The contraction in national income following appreciation has effects opposite those following depreciation. Price changes thus do not tell the whole story; rather, their equilibrating effects are reinforced by the effects of changes in income. Jointly they constitute a powerful force for the maintenance of equilibrium in the balance of payments over the long run.

As in the case of the gold standard, it is important to note that the adjustments in the balance of payments resulting from changes in price and income may be entirely, or largely, offset through the medium of monetary or fiscal action. It is possible, however, for such policies to be employed in a manner to speed up or ease the adjustment process.

The Role of Short-term Capital Movements

As in the case of the gold standard, so under an inconvertible-paper standard speculative short-term capital movements play an important role in the process of balance-of-payments adjustment. But, unlike the situation under the gold standard, where short-term capital movements are virtually always *stabilizing* in character, under inconvertible paper they frequently are *destabilizing*. Short-term capital movements are said to be stabilizing when they assist in promoting balance-of-payments adjustment, but are said to be destabilizing when they intensify the deficit or surplus which must be dealt with through an adjustment process.

The case of a stabilizing short-term capital movement, discussed in connection with adjustment under the gold standard, may be briefly reviewed. If exchange dealers anticipate, for example, that a rise in a country's rate of exchange is only temporary, their actions may set in motion a short-term capital inflow. Domestic exchange dealers may draw down their foreign balances below normal in order to take advantage of the relatively high exchange rate which prevails; in addition, dealers abroad may be willing to build up their balances in the country in which the rate has risen. Between the two, there is an addition to the current supply of relatively scarce foreign exchange, the effect of which is to help stabilize the rate of exchange.

Some short-term capital movements under inconvertible-paper standards, however, are destabilizing in nature. If a rise in the rate of exchange is expected to continue, imports tend to increase (because of the expectation that higher import prices will prevail in the future) and exports tend to decline (because foreigners come to expect lower import prices in the future). The result is an increase in the demand for foreign exchange (relative to supply), and a further rise in the rate of exchange. In addition, the expectation of a higher rate in the future induces a speculative capital outflow as speculators acquire foreign-exchange balances which they expect later to convert back into domestic currency at a profit to themselves. Such action by speculators has the effect of pushing the rate still higher.[6]

To the extent that short-term capital movements of the stabilizing variety occur, their effect is to tone down the fluctuations in exchange rates. In a sense, the movement of short-term capital (of the stabilizing variety) is akin in its stabilizing effects to the movement of gold under the gold standard.

Exchange-Stabilization Operations

Though the rate of exchange under an inconvertible-paper currency is theoretically free to fluctuate without limit, relative stability may be sought through official intervention in the exchange market. Governments on occasion initiate exchange-stabilization-fund operations in an attempt to tone down short-run fluctuations, if not indeed to maintain long-run, exchange-rate stability at "pegged" rates. The essence of the stabilization procedure, as explained in the preceding chapter, is that the government, i.e., the treasury or central bank, intervenes as an active foreign-exchange trader, purchasing foreign currency with domestic currency in order to prevent the appreciation of the domestic currency, and selling foreign currency for domestic currency in order to prevent a depreciation of the domestic currency. To the extent that governments intervene in the foreign-exchange market to maintain a stable exchange rate, the system tends to operate in a fashion not unlike that prevailing under gold-standard conditions.

[6] The basic reason gold-standard conditions yield different results from inconvertible-paper conditions is that fluctuations under the gold standard are limited by the gold points, while under inconvertible paper there is no such limit. The essential fact is that there is a broader scope for speculation, commodity and monetary, under a freely fluctuating exchange rate, where the future rate may differ widely from the current rate, than under the relatively fixed exchange rate of the gold standard. Destabilizing short-term capital movements tend to exist under a gold standard only when devaluation — a change in the gold content of the monetary unit, and hence of the rate of exchange — or abandonment of the gold standard itself are regarded as possibilities.

BALANCE-OF-PAYMENTS ADJUSTMENTS UNDER EXCHANGE CONTROL

Sometimes a country does not wish to adhere either to a freely fluctuating exchange rate or to a fixed exchange rate as it was known under gold-standard conditions. At best, a freely fluctuating rate varies in somewhat uncertain fashion. On occasion, too, pressure for depreciation may prove too strong to be successfully offset through stabilization-fund operations. Yet a country may wish to avoid depreciation and the worsened terms of trade which follow from it. On the other hand, a fixed rate under gold-standard conditions may not be regarded as a meritorious alternative. The typical country may not be prepared to undergo adjustments within its domestic economy of the type required by adherence to such a system. In this case, a third system — exchange control — may be relied upon. Exchange control, in reality, promotes relative exchange stability, but does so without necessitating a return to the gold standard.

Exchange control, as explained in the preceding chapter, involves direct governmental control of foreign-exchange operations. The degree of control exercised by the government varies widely from country to country. In general terms, however, exchange control is a system which allows a country to *mobilize* the foreign exchange accruing to its residents and to *ration* this foreign exchange among those residents who demand foreign exchange. In this way, a government can restrict the effective demand for foreign exchange so that the supply available may prove adequate under a given rate of exchange, even though the latter rate may be at a vastly overvalued level. Under exchange control, control over foreign-exchange transactions is ordinarily the basic means relied upon to promote adjustments in a country's balance of payments, at least in the short run. It is significant, however, that exchange control promotes "balance" in a country's balance of payments by *forcibly* confining the demand for foreign exchange within limits of the supply available. *Equilibrium is made to exist in a statistical sense,* but not in a free-market sense.

In the process of controlling imports through exchange control, prices and incomes are affected. First, the restriction of imports tends to create domestic scarcities and thus to raise prices within the control country; on the other hand, prices abroad tend to decline, largely because goods normally exported by the foreign countries begin to pile up when the adoption of exchange control elsewhere curtails their export markets. Relatively higher prices in the control country tend to curtail its exports, necessitating the adoption of more stringent exchange-control measures in

order to further restrict imports to a level in conformity with the new lower level of exports.

Second, the restriction of imports serves, in and of itself, to increase the national income of the control country as domestic goods come to some extent to displace goods previously imported. The relatively greater income, in turn, tends to divert goods from the export market to the domestic market. On the other hand, the restrictions placed upon imports in the control country automatically entail a loss of export markets for other countries, thereby bringing about a contraction in the level of income of the latter countries. As their incomes decline, their imports from the control country tend to decrease. The composite result of developments in the control country and in foreign countries is to increase the demand for foreign exchange in the control country relative to the supply of foreign exchange becoming available to it. Again, as in the case of a relative price increase, the relative increase in income in the control country may necessitate the adoption of more stringent import restrictions so as to confine the demand for foreign exchange within the limits of the lowered supply of foreign exchange becoming available.

According to the foregoing analysis, exchange control tends to bring about relative changes in prices and incomes, and the latter changes, in turn, tend to intensify the balance-of-payments disequilibrium which initially may have provided the reason for instituting exchange control. It is in this way that exchange control, once adopted, may create a situation in which it comes to perpetuate itself. Despite this apparent weakness, it must be admitted that exchange control provides a potent method for forcing an adjustment in a country's international accounts when disequilibrium prevails, without the country having to alter its exchange rate.

EQUILIBRIUM: FIXED VERSUS FLUCTUATING EXCHANGE RATES

Under the international gold standard as it existed prior to World War I, exchange rates were relatively fixed, being free to fluctuate only within the narrow range circumscribed by the gold points. Adjustment in a country's balance of payments thus was very largely dependent upon changes in domestic prices and in domestic levels of income and employment. Such adjustment was automatic and, in practice, took place with surprising smoothness and certainty, at least as long as the government maintained a hands-off policy.

This mode of adjustment, however, was not always viewed with unfettered enthusiasm. Rather, it came to be regarded with both concern

and misgiving, especially in those countries heavily dependent upon foreign trade. The basic point of dissatisfaction rested upon the fact that under the international gold standard a country's domestic economy was vulnerable to repercussions arising abroad. Such vulnerability existed because each country, acting in accordance with the "rules" of the gold-standard game, was obliged to allow its domestic economy to adapt freely to changes in the international environment. In practice this meant that a loss of gold through the adjustment process paved the way for deflation in the domestic economy; the receipt of gold, on the other hand, tended to produce inflationary effects. The various economies were thus linked by gold, the free movement of which served to transmit economic repercussions from one country to another.

Proponents of the gold standard were quick to emphasize that such repercussions were temporary phenomena and that, in fact, they were a necessary element in the process of re-establishing international equilibrium. For example, deflation was shown to be self-limiting in that a declining domestic price level (relative to other countries) tended to encourage exports and to discourage imports; similarly, inflation was shown to be self-limiting in that a rising domestic price level (relative to other countries) served to reduce exports and to increase imports. Rather than to regard deflation and inflation as situations to be prevented or fought, supporters of the gold standard in true *laissez-faire* fashion were inclined to view them as mere transition phases in the process of arriving at a new international equilibrium. Viewed in this way, anti-deflationary or anti-inflationary measures at the domestic level only served to prolong existing maladjustments in the international framework and thereby tended to delay the new equilibrium which, it was felt, eventually had to evolve, and hence the sooner the better. In short, the essential notion under the gold standard was that international stability was primary, and that adjustments within the domestic economy should be allowed to occur in order to promote domestic stability in a manner compatible with international stability.

Not everyone was convinced of the merits of a system which placed primary emphasis upon international stability, and which left the domestic economy to adjust to international forces as best it was able. There were those who felt, either as a matter of principle or as a matter of practical public policy, that domestic stability should be an individual country's first concern, even if the achievement of this objective had to occur at the expense of international stability. At best, this view held that international stability should follow from domestic stability, rather than the other way around.

In any event, it was only a matter of time before this thought was translated into action. The first major interference with the automatic correctives of the gold standard arose when central-banking techniques came to be employed in an attempt to tone down domestic instability. These policies were soon reinforced by the potentially stronger fiscal-policy measures initiated by treasury authorities in various countries. Needless to say, such monetary and fiscal-policy measures on many occasions seriously jeopardized the effective operation of the gold standard. The usual objective of such measures was to offset or resist the very adjustments required of the respective countries under gold-standard conditions.

If it was true that the monetary and fiscal-policy measures adopted by the various countries impeded the operation of the gold standard, it was also true that the attempts by individual countries to do something of a monetary and fiscal-policy nature to stabilize their economies tended to run up against distinct limitations imposed by the gold-standard conditions. For example, a loss of gold under the gold standard entailed some domestic deflation, but it also served to increase exports and to decrease imports, the latter trade shifts in turn limiting contraction in the domestic economy and restoring international equilibrium. Whenever a government instituted monetary or fiscal-policy measures in an attempt to prevent such deflation, however, not only was international adjustment thwarted, but the continued high volume of imports flowing into the country constituted a leakage which drew down the country's foreign-exchange reserves and which seriously undercut the domestic efforts at stabilization. Expansionary policies tended to be similarly undermined. Whenever a country introduced a domestic expansionary program, the resultant increase in domestic prices and incomes tended to invite a greater inflow of goods and services; but these imports, coupled with reduced exports, tended to diminish the effectiveness of the domestic effort.

In short, the operation of the international gold standard was not conducive to independent domestic planning; in fact, the two were basically incompatible. If the automatic gold standard was to operate smoothly and positively, there was no room for independent domestic measures which only constituted obstructions to the free adjustment process. If, on the other hand, domestic measures proved strong enough to provide domestic stability outside the gold-standard mechanism, the latter could hardly have been expected to achieve its purposes, or even to endure.

The precise date of the breakdown of the international gold standard

is difficult to fix since the process of disintegration covered at least two decades. It was the accepted system until World War I, but during the war its operation was of necessity temporarily suspended. After the war the system was re-created, but it did not recapture its old acceptance, nor did the new environment allow it to function with its former smoothness. With the advent of the Great Depression, new and pressing problems arose. These gave impetus to the spirit of economic nationalism, and country after country formally renounced the gold standard. Such action by Great Britain in 1931 constituted a crippling blow, and it was soon followed by similar action on the part of other countries, e.g., the United States in 1933 and the so-called "gold-bloc" countries — France, Belgium, the Netherlands, and Switzerland — in 1935-36. Individual countries continued to define their currencies in terms of gold, and indeed gold continued to move in international trade, especially as a commodity, but the automatic mechanism for adjustment, which formerly constituted the "heart" of the gold-standard mechanism, no longer remained in force.

In retrospect, it was the desire on the part of countries to plan their economic destinies unilaterally rather than to leave them to the whim of international forces which, more than any other factor, was responsible for the breakdown of the international gold standard and the substitution for it of a series of independent "managed" currencies. The international gold standard had long been regarded in some quarters as nothing less than a "strait jacket" which prevented adherents from "putting their own houses in order."

Once countries had cut loose from the international gold standard and moved to inconvertible paper, they were relatively unencumbered in their attempts to pursue monetary and fiscal-policy measures of their own choice. At least, whenever thereafter they chose to act on their own accords, such acts were no longer in the nature of violations of "rules." It was precisely this greater freedom for independent domestic action ("planning") which appealed to countries at the time, and which constituted the basic motivating force behind the adoption of the new currency systems. This is not to imply that countries, having severed their ties to gold, and having acquired this new freedom of action, were also at the same time freed of the problems associated with the process of balance-of-payments adjustment. The latter problems remained to be dealt with, but, significantly, the point of emphasis in the process of adjustment was altered. Henceforth, each country was able to place far greater reliance for adjustment between its economy and the rest of the world upon variations in its rate of exchange, and adjustment through price and income tended to become subsidiary to changes in the rate of exchange. The crucial point was that

the rate of exchange was now theoretically free to move without limit; to the extent that it did respond in the adjustment process, some of the pressure was removed from price and income (at least in an initial sense).

It was not long, however, before countries sought to combine their newly acquired freedom of domestic action with direct intervention in the process of balance-of-payments adjustment itself. Because of the disinclination of individual countries to accept, under any and all conditions, the consequences of a widely fluctuating rate of exchange (e.g., the worsened terms of trade which accompanied depreciation), it was only natural that ways were sought which might allow a country to maintain its exchange rate at a desired level, despite the fact that independent domestic measures continued to be pursued. Exchange-stabilization funds provided limited assistance, but it was exchange control, more particularly, which came to be relied upon in this connection.

Once a country adopted exchange control, it was able to insulate its economy, more or less, against the rest of the world. Whenever its domestic policies tended to produce disequilibrium in its balance of payments, exchange-control regulations could always be manipulated in a manner to force an equilibrium (although the latter reflected a forced balancing of accounts, as distinct from a free-market equilibrium). In fact, a country was able to pick an international value for its currency, within broad limits, and to maintain this value thereafter through the procedure of rationing available exchange. Actually, any one of several exchange rates may provide "balance" in a country's international accounts, provided exchange control is freely used to promote this end.

In short, the international gold standard placed primary emphasis upon international stability, and it was hoped that domestic stability might follow from it; under inconvertible paper, in contrast, primary emphasis was placed upon domestic stability, and it was hoped that equilibrium between a given country and the rest of the world might then occur either through changes in the country's exchange rate (primarily, or at least initially) or through use of exchange control (the latter involving a forced balancing of international accounts). A major advantage of the international gold standard was the automatic nature of its operation, while a major drawback was found in the obstacles it raised to domestic economic planning; in contrast, a major advantage of an independent, "managed" currency was the freedom it allowed for domestic planning, while its big drawback was that it replaced a purely automatic system with one in which basic decisions were man-made, and hence subject to human failings.

THE THREE SYSTEMS: A RÉSUMÉ

Adjustments in a country's balance of payments may occur under either a (1) gold-standard currency or an (2) inconvertible-paper currency. The gold standard gives rise to a (*a*) fixed rate of exchange, while under inconvertible paper either a (*b*) fluctuating rate of exchange or (*c*) exchange control exists. The manner in which adjustment occurs in the balance of payments under each of these sets of conditions may be summarized as follows:

(*a*) When a country adheres to the gold standard, its rate of exchange is fixed. The presumption is that the domestic economy, through the government's pursuit of appropriate monetary and fiscal policies, as well as through changes in the level of prices and of national income, will adapt itself in a manner which will serve to equilibrate the supply of and demand for foreign exchange, and thereby produce equilibrium in the balance of payments.

(*b*) When a country operates under inconvertible paper, and has a fluctuating rate of exchange, the situation which prevails is roughly the opposite of that under the gold standard. Wide latitude is reserved for independent domestic planning, the exchange rate being free to seek a level which will serve to equilibrate the supply of and demand for foreign exchange, and thereby produce equilibrium in the balance of payments.

(*c*) A country operating under inconvertible paper may also rely upon exchange control. Exchange control combines elements of both the foregoing systems. Wide scope for independent domestic planning is retained, but a relatively fixed exchange rate is also maintained. The latter is accomplished through the allocation of foreign exchange in a manner such that the effective demand for foreign exchange at the existing rate of exchange cannot exceed the supply becoming available at that rate. The balance of payments is forcibly brought into balance; balance-of-payments equilibrium in a free-market sense cannot be said to prevail.

The essential differences between the three systems may be summarized in diagrammatic fashion. In Fig. 5[7] the demand for foreign exchange (*DD*) is shown to exceed the supply of foreign exchange (*SS*) at the prevailing exchange rate *OX* by an amount *AB*. Under a fixed exchange rate, domestic policies would be altered so that supply and de-

[7] Adapted from C. P. Kindleberger, *International Economics* (Homewood, Ill.: Richard D. Irwin, Inc., 1953), Fig. 4.1, p. 59.

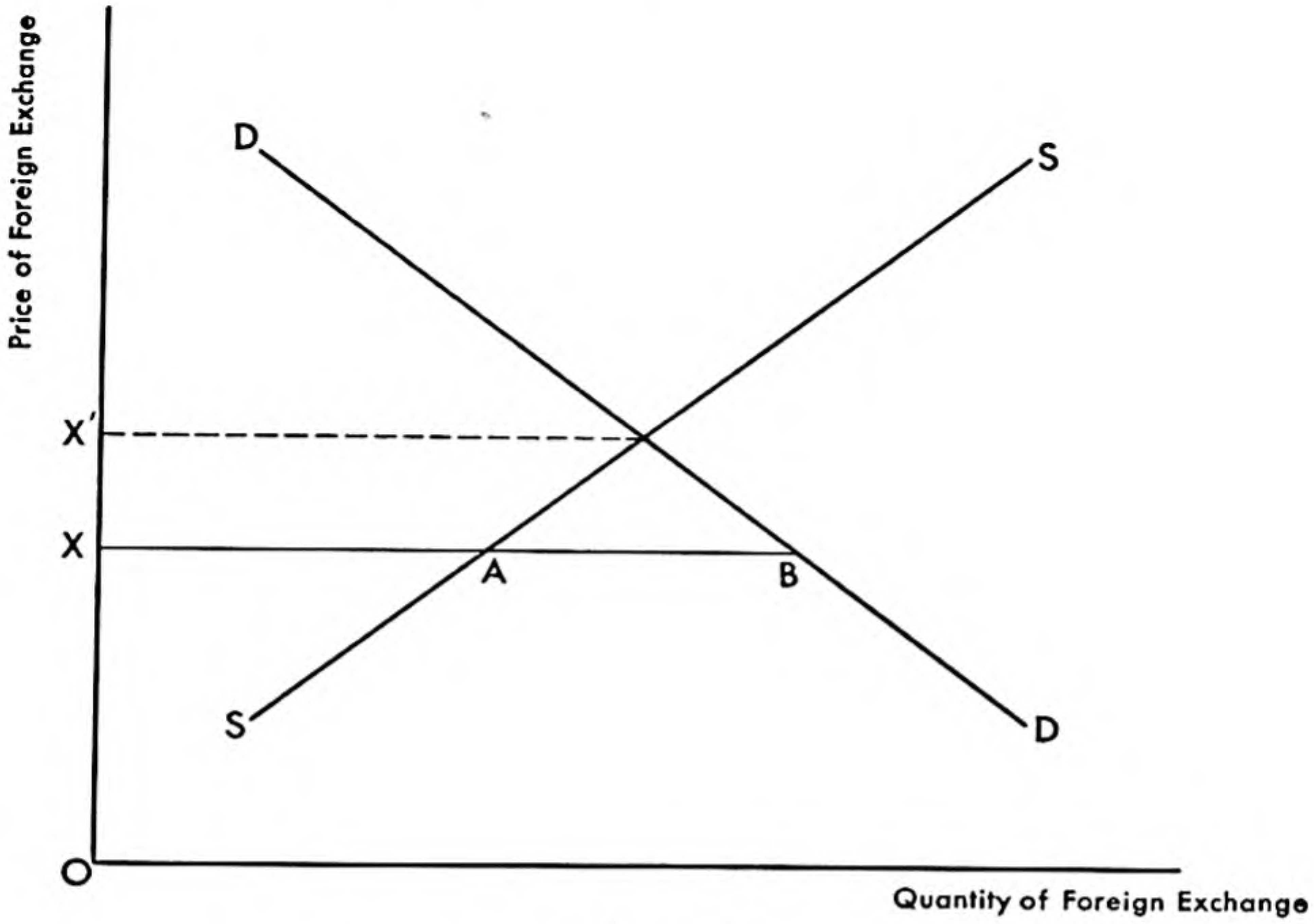


Figure 5

Comparison of Fixed Exchange Rates, Fluctuating Exchange Rates, and Exchange Control

mand (following shifts in the curves) would equilibrate in a free market at price *OX*. Under a fluctuating exchange rate, changes in domestic policies would likely be considered unnecessary; rather, the forces of supply and demand would be freely permitted to bring about the equilibrium price *OX′*. Under exchange control, the price *OX* would be maintained by means of an allocation of the available supply *XA* among persons demanding the quantity *XB*, so that the portion of the demand represented by *AB* would remain unfilled.

SUMMARY

When a disequilibrium arises in a country's balance of payments, certain adjustments occur which tend to restore equilibrium. Under free-market conditions, these adjustments occur automatically through changes in (*a*) exchange rates, (*b*) prices, and (*c*) incomes. Under a gold standard, the rate of exchange is free to fluctuate only within limits of the gold points, so that the brunt of the adjustment process is ordinarily borne by changes in prices and incomes. Changes in the latter affect the course

of trade, and hence the supply of and demand for foreign exchange. Equilibrium in the balance of payments requires that the supply of and demand for foreign exchange be equal. Under inconvertible paper, the rate of exchange is free to fluctuate without limit. Changes in this rate, along with changes in prices and incomes, again act to equate the supply of and demand for foreign exchange.

A country unwilling to submit to adjustment under free-market conditions may employ exchange control to restrict the demand for foreign exchange to the supply available, the rate of exchange being held stable. "Balance" in the balance of payments is then attained through forcible means (as distinct from being the product of free-market forces).

SELECTED REFERENCES

Brown, W. A., Jr., *The International Gold Standard Reinterpreted, 1914-1934.* New York: National Bureau of Economic Research, 1940, 2 vols

°Condliffe, J. B., *The Commerce of Nations.* New York: W. W. Norton & Company, Inc., 1950, Chaps. XII, XIX-XX.

°Halm, G. N., *Monetary Theory.* Philadelphia: The Blakiston Company, 1946, Chaps. 11-14.

League of Nations, *International Currency Experience,* Geneva, 1944, Chaps. IV-VII.

°Machlup, F., *International Trade and the National Income Multiplier.* Philadelphia: The Blakiston Company, 1943.

°Meade, J. E., *The Balance of Payments,* Vol. 1. New York: Oxford University Press, 1951, Parts II-VI.

Metzler, L. A., "A Multiple Country Theory of Income Transfers," *Journal of Political Economy,* February, 1951.

———, "The Theory of International Trade," in H. S. Ellis (ed.), *A Survey of Contemporary Economics.* Philadelphia: The Blakiston Company, 1948.

°Nurkse, R., "Conditions of International Monetary Equilibrium," reprinted in American Economic Association (ed.), *Readings in the Theory of International Trade.* Philadelphia: The Blakiston Company, 1949.

°———, "Domestic and International Equilibrium," in S. E. Harris (ed.), *The New Economics.* New York: Alfred A. Knopf, Inc., 1947.

Part III

National and International Controls

We have learned that the economic justification for international trade revolves about the better utilization of productive effort and the higher standard of living which it permits and promotes. In practice, however, countries are prone to adopt various measures and policies which seemingly preclude them from reaping all the gains from trade which might be theirs. The goal in Part III is to examine the nature, purpose, operation, and effect of some of the national and international controls, public and private, which have come to be applied to international trade.

6

The Tariff: I

FREE TRADE, the flow of international commerce in an environment free of man-made impediments, is consistent with the maximization of the advantages to be obtained from the international division of labor. If each country produces that in which it has the greatest relative advantage, or the least relative disadvantage, and if each country then carries on trade with other countries, the result, as we observed earlier, is a larger output (for effort expended) for the trading world as a whole. This, very simply, is the case for free trade.

The advantages of free trade would appear to place its practice beyond question, yet we find that country after country has in effect barriers which impede the flow of international commerce and which channel domestic production along particular and generally less economic lines. Of these barriers, the tariff is the oldest and perhaps best known. Also included, however, are import quotas, exchange-control systems, state-trading operations, and various forms of international combination.

This chapter and the one following are devoted to the tariff. The subsequent chapters in Part III treat other forms of trade controls. In examining the various forms of trade controls, the following pertinent question may in each case be borne in mind: Why, despite the apparently conclusive argument in favor of free trade, have impediments to the free flow of trade arisen?

THE PREVALENCE OF TARIFFS

Tariffs represent an old form of restriction upon trade, dating at least from medieval times. The tug-of-war between free trade and restriction has been going on for a long time. The situation today is that no country practices absolute free trade, although the extent of dependence upon tariffs varies widely among countries. The United States has in effect an elaborate system of tariffs, although the country is less dependent upon tariffs today than it was, say, a generation ago. Great Britain, for several centuries the world's foremost exponent of relatively free trade, began to rely upon tariffs to a greater extent beginning in 1932. Most Latin-American countries have long been heavily reliant upon elaborate tariff structures, utilized in large part for the purpose of raising governmental revenue. Elsewhere, too, tariffs have long been widely used to serve a variety of purposes.

CLASSIFICATION OF TARIFFS

Tariffs may be classified in a number of ways. Two important modes of classification include the *purpose* they serve, and the type of *rate structure* they employ.

(1) A tariff may be designed for either *revenue* or *protection*. Revenue tariffs ordinarily carry relatively low rates of duty, and are not intended to exclude imports. They are typically levied on articles of widespread domestic consumption when the entire supply is imported. Protective tariffs, on the other hand, are designed to curtail the importation of commodities competitive with similar domestically produced commodities. Completely protective tariffs allow no importation, and hence yield no revenue whatever. Most protective tariffs, however, are not sufficiently restrictive to eliminate all imports, and they thus continue to yield some revenue. Such tariffs then combine protective and revenue qualities, and in borderline cases it may prove difficult to classify their primary intent.

(2) Rates of duty may be either *specific, ad valorem,* or *specific-ad valorem*. Specific duties are flat levies per physical unit, such as 20¢ per bushel of wheat or $10 per ton of steel. Ad valorem duties, in contrast, are levied as a percentage of value, such as 10 per cent of the value of an automobile. The relative burden of ad valorem duties thus does not change with fluctuations in import prices, whereas specific duties become relatively more or less burdensome as changes occur in prices. Specific duties increase as a percentage of value as prices decrease, and vice versa,

and are for this reason more protective during depression than during prosperity (assuming a constancy of rates). In order to overcome this effect, specific-ad valorem duties are sometimes used. These ordinarily provide that commodities are to be dutiable at either the specific rate or the ad valorem rate, whichever is lower. For example, wheat may be made subject to a specific rate of 20¢ per bushel or to an ad valorem rate of 10 per cent, whichever of the two charges proves lower.

THE CUSTOMS AREA

A *customs area* is that geographical area within which commodities are free to move without becoming subject to duty. The customs boundaries of a country need not be identical with its political frontiers. A customs area may include, for example, not only a country's home territory, but also relatively distant dependent territories. Thus, the customs area of the United States includes the continental United States plus some non-contiguous territories, including Alaska, Hawaii, and Puerto Rico. Similarly, a customs area may embrace two or more sovereign countries, giving rise to what is known as a *customs union*. A notable historical example of a customs union is found in the German Zollverein. Following World War II, Belgium, the Netherlands, and Luxembourg formed a customs union ("Benelux"), thereby clearing the way for the relatively unrestricted exchange of goods among the three countries.

THE HEIGHT OF A TARIFF

It is frequently useful to compare the heights of tariffs prevailing in various countries or to compare the heights of tariffs prevailing at different times in the same country. But how may we measure the height of a tariff? One possible method is to divide the total amount of duties collected by the total value of goods imported in order to obtain a percentage which may then be compared with similarly derived percentages for other countries or time intervals.[1] This method is generally considered unsatisfactory, however, since the more protective some duties become, the lower tends to be the aggregate volume of dutiable imports, and the greater tends to be the proportion of total imports which enter duty-free or at relatively low rates of duty. Thus, if duties are completely protective, excluding all dutiable commodities, imports consist solely of tax-free commodities. The height of the tariff then appears to be zero, an absurd conclusion!

[1] This method has been used extensively by The American Tariff League. E.g., see "*How Low Are United States Tariffs?*" Publication No. 133, The American Tariff League.

A preferable method is to transform all duties into ad valorem terms, compute an average (weighted) ad valorem rate, and express this rate as a percentage of the average (weighted) value of all dutiable commodities (including those excluded by protective duties). This method may prove cumbersome from a statistical standpoint of view; for example, the determination of a satisfactory percentage-index requires that the average value of each commodity be ascertained and that each commodity be weighted according to its relative importance in international trade, neither of which is a simple matter. Assuming that a satisfactory percentage-index can be devised, it must still be recognized that it is entirely possible for a given ad valorem rate to prove more protective in the case of one commodity or country than for a relatively higher ad valorem rate in the case of another commodity or country; the precise amount of protection which results from duties depends also on the elasticities of supply and demand for the commodities concerned. Despite these obvious difficulties, the expression of some average of ad valorem rates as a percentage of some average value of dutiable imports may prove useful in providing a rough measure of the differences in the heights of tariffs between countries and time intervals.

WHO PAYS THE TARIFF?

Upon whom does the cost of a tariff fall? One extreme view is that a tariff is a tax upon the foreign supplier, while another equally extreme view is that it is a tax upon the ultimate consumer. While cases exist which bear out both of the foregoing situations, the usual situation lies somewhere in between. In general, four sets of conditions are readily distinguishable. The imposition of a duty may leave the domestic price unaffected, it may raise the domestic price by less than the amount of the duty, it may raise the domestic price by an amount equal to the duty, or it may raise the domestic price by more than the amount of the duty.

(1) A tariff has no effect upon the domestic price when levied upon a commodity whose supply is more than adequate to fill normal domestic demands, leaving a surplus for export. The reason for this may readily be grasped by reference to a historical example. Following World War I the United States imposed a duty of 42¢ per bushel on wheat in the hope of raising the domestic price above the world level. The country, however, had a regular exportable surplus of wheat, and this fact, in and of itself, was sufficient to doom the tariff action to failure. Why such of necessity was the case may be seen by examining what would have happened had the price of wheat actually risen, even momentarily, above

the world level. In such event, domestic wheatgrowers would have preferred to market all their wheat at home. The demand for wheat being what it is, such mass sales in the domestic market would have forced the price back down at least to the world level. When there is an exportable surplus, therefore, the domestic producer is able to receive no more than the world price for his product, and this is true with or without a tariff. Only if some form of production-control or marketing-control, designed to reduce the supply of a commodity entering the domestic market, is enacted to parallel the tariff may the domestic price be maintained above the world level.

(2) A tariff tends to raise the domestic price by an amount less than the full value of the duty if the dutiable commodity is produced at increasing costs (i.e., additional units of supply can be produced only at a higher per-unit cost). Since under conditions of free trade there tends to be an equality of prices between markets (exclusive of transport costs), the initial effect of a duty is to cause foreign and domestic prices to differ by that amount (unless, of course, the duty is completely protective). Additional effects follow. The higher price in the importing country leads to a reduction in consumption and perhaps to an increase in production, although the latter may occur only at higher per-unit costs (under increasing-cost conditions). In the exporting country, on the other hand, the decline in export sales entails reduced output, lowered costs (under increasing-cost conditions), and perhaps increased consumption. The end result is a price in the importing country which is higher by somewhat less than the full amount of the duty.

The nature of the foregoing adjustment may be shown diagrammatically. In Fig. 6[2] are shown the conditions of supply, demand, and price for a given commodity produced under increasing costs in two countries, M and X. In a non-trading world, each of the countries produces the particular commodity: M produces (and consumes) the quantity P_iH at price OP_i; X produces (and consumes) quantity p_ih at price Op_i.

If trade is introduced, X begins to export (since its price is relatively low) and M begins to import (since its price is relatively high). Assuming that there are no transport costs, one price must come to prevail. This price must be such that the combined supplies of X and M are just equal to the combined demands of X and M (i.e., the quantity supplied by the exporting country, X, in excess of its domestic consumption must be equal to the quantity demanded by the importing country, M, in excess

[2] Figs. 6 and 7 are based on graphs used by J. H. Myers, "Tariffs and Prices: A Diagrammatic Representation," *American Economic Review,* September, 1941, pp. 554, 555.

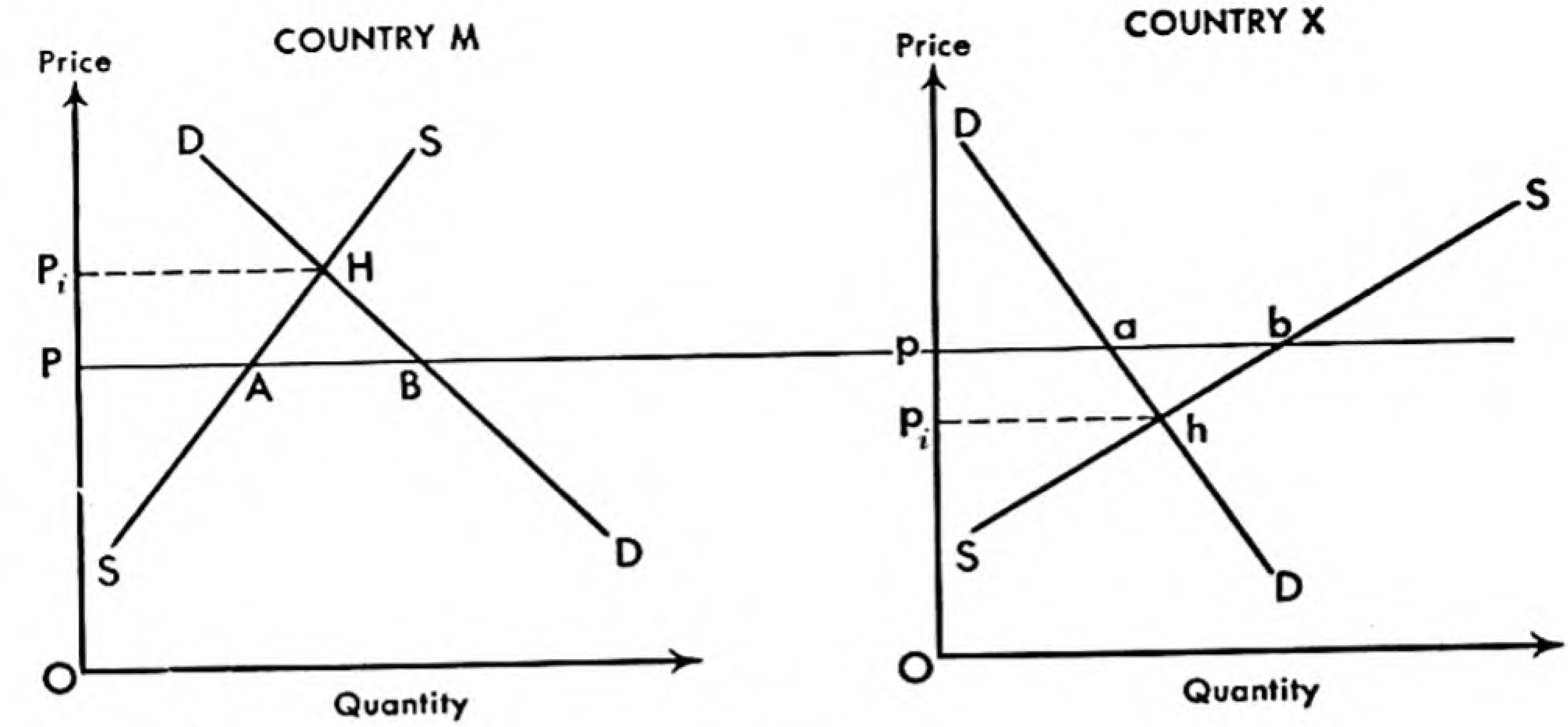


Figure 6
Incidence of a Tariff

of its domestic supply). The level of the latter price may be shown by moving the horizontal line, *Pp*, up or down until *ab* is equal to *AB*, i.e., until X's excess supply is equal to M's excess demand. The effect upon M of the introduction of trade, then, is to reduce price from OP_i to OP, to reduce production from P_iH to PA, and to increase consumption from P_iH to PB. Imports amount to AB. The effect upon X is to raise price from Op_i to Op, to increase production from p_ih to pb, and to reduce consumption from p_ih to pa. Exports amount to ab $(=AB)$.

Under the foregoing conditions, what is likely to happen if M imposes an import duty? If the duty is completely protective, its effect is to separate the markets of the two countries, thereby restoring the situation existing

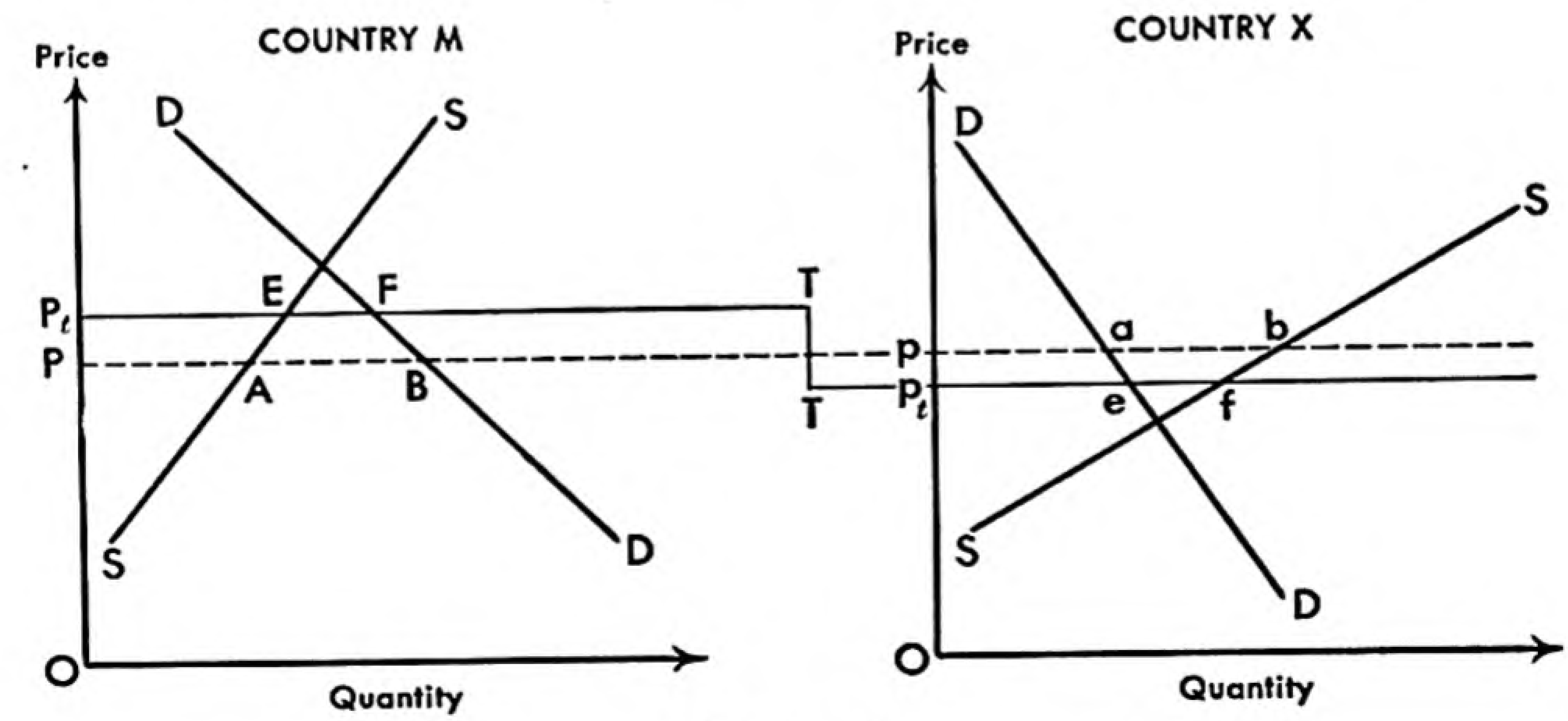


Figure 7
Incidence of a Tariff (continued)

before the introduction of trade. Let us assume a situation, therefore, in which the duty is less than completely protective. This situation is shown in Fig. 7, the duty being *TT*. The price in M must be greater than the price in X by an amount *TT* if there is to be trade. But the equilibrium condition remains the same: the amount supplied in X in excess of its own demand must be equal to M's excess of demand over domestic supply. The new equilibrium may be shown by sliding the jogged line P_tTTp_t, up or down until *EF* is equal to *ef*, at which point X's exports equal M's imports. We may add a broken line, *Pp*, to our graph in order to facilitate comparison of the market under conditions of free trade and under conditions of a tariff. It is at once apparent that the effect of a tariff upon M is to increase price from *OP* to OP_t and production from *PA* to P_tE, but to reduce imports from *AB* to *EF* and consumption from *PB* to P_tF. The effect upon X is to reduce price from *Op* to Op_t, to reduce production from *pb* to p_tf, to reduce exports from *ab* to *ef*, but to increase consumption from *pa* to p_te.

In summary, the effect of the tariff upon the importing country is to increase price and output, but to lower importation and consumption; in the exporting country, price, output, and exportation are reduced, but consumption is increased. Although the price differential between the two countries is equal to the full amount of the duty, the price in the importing country (M) is increased by an amount less than the duty ($PP_t < TT$). The precise price effect under the foregoing conditions depends basically upon the volume and elasticity of supply and demand in the trading countries.[3]

(3) A tariff tends to raise the domestic price by the amount of the duty if the dutiable commodity is produced at constant costs (i.e., additional units of supply can be produced at the same cost per unit as a smaller supply) and if the foreign price of the dutiable commodity plus the duty amounts to less than the domestic cost of production. The entire supply then continues to be imported, though higher prices (by the amount of the duty) serve to reduce the volume of importation.

(4) Finally, it is possible for a duty to result in the domestic price of a commodity being raised by an amount greater than the duty. This is possible because imports do not reach the consumer directly, but pass through the hands of middlemen, each of whom adds a markup which ordinarily is computed as a percentage of the import price plus the duty.

[3] For an excellent discussion of the price effects of tariffs under the above conditions, see G. Haberler, *The Theory of International Trade* (New York: The Macmillan Company, 1950), Chap. XV.

When commodities pass through a series of hands in this fashion, the actual duty paid may be pyramided into a substantially larger charge before being passed on to the ultimate consumer.

SOME EFFECTS OF A TARIFF

We have observed that a tariff may affect prices, output, and consumption. Other important effects also occur, three of which we may cite here: (1) the effect upon the volume of exports, (2) the effect upon the terms of trade, and (3) the effect upon the balance of payments.

Volume of Exports

A tariff on imports may serve to reduce exports. The logic behind the foregoing statement stems from the concept of reciprocal demand. The imposition of a tariff by a country tends to lead to a smaller volume of imports, and hence to a smaller volume of foreign-exchange earnings for foreign exporters; the latter development, in turn, tends to reduce the export markets for the goods of the tariff country.

While a particular domestic industry, or industries, may gain from the imposition of a tariff, it follows from the principle of reciprocal demand that the gain occurs, at least in part, at the expense of other domestic industries, namely, the export industries. The loss of potential exports causes those factors of production oriented to the export industries to receive an income smaller than would otherwise be possible.

Terms of Trade

The imposition of a tariff may serve to improve a country's terms of trade (i.e., the amount of imports it receives for a given volume of exports), particularly if the foreign demand for the goods of the tariff country is relatively large and inelastic. The effect of the tariff is to reduce imports somewhat, making it more difficult for foreigners to earn the means to continue purchases in the tariff country. Foreigners, therefore, may feel compelled to reduce their prices in an attempt to expand exports to a level which will restore their earlier capacity to finance purchases in the tariff country. The effect of a tariff under these circumstances is to lower import prices relative to export prices, thereby improving the terms of trade for the tariff country.

It is to be noted that the improvement in the terms of trade of a particular country is paralleled (or preceded) by a reduction in the volume of imports. The attempt by one country to gain at the expense of another (or others) in this manner, however, may not go unchallenged;

rather, such action on the part of one country may be met by retaliatory measures of one sort or another on the part of another country (or countries). In this event, the effort of a single country to gain a national advantage produces the next effect of harming *all* countries, since the new restrictions which arise serve to bring about a generally poorer utilization of productive effort. Even in the absence of retaliation, the tariff country may experience a significant loss of potential gains from trade, provided the volume of trade is markedly reduced.

Balance of Payments

Among the more important effects of a tariff is that upon the balance of payments. A country which might otherwise have a deficit in its balance of payments may conceivably achieve equilibrium by means of tariff restrictions (or other restrictions) upon imports. The process of promoting equilibrium in this manner has been severely criticized in some quarters. First, the resultant equilibrium occurs through a contraction of trade, which necessarily appears bad in the light of the advantages to be gained from a large and expanding volume of world trade. Second, the foregoing method of adjustment produces the formal outward appearance of equilibrium, but it does so without getting at the fundamental cause of the previous disequilibrium. There usually are other and better means for promoting balance-of-payments equilibrium, among them being the adoption of appropriate domestic monetary and fiscal measures or the adjustment of the exchange rate.

On the other hand, the imposition of new or higher tariffs may serve to aggravate disequilibrium if such already exists in a country's balance of payments. For example, the United States long experienced an export surplus; exports of goods and services exceeded like imports during the post-World War II years (Table 16, Chapter 3).[4] New or higher tariffs under these circumstances tend to accentuate the balance-of-payments problems of this country and of those countries in which deficits prevail. In further restricting its imports, the United States makes it more difficult for foreigners to earn the dollars needed by them to pay for purchases made in this country. The situation is further complicated by the fact that the United States, as a creditor country, has a claim upon foreigners for interest, dividends, and the repayment of capital. The transfer of these amounts properly requires that the creditor accept an import surplus (unless it is willing to undertake additional offsetting foreign investments). The tariff

[4] According to other computations (which classify military items in a slightly different manner), the United States had an export surplus of goods and services during the years 1946-52, but did not during 1953 (see Table 23, Chapter 14).

thus stands as an obstacle to the movement of goods which constitute one of the means of payment.

EXPORT DUTIES

Export duties are common among raw-material-producing countries, but are little used by industrial countries. These taxes are ordinarily levied in the belief that they are passed on to foreign purchasers of raw-material exports. Their incidence, however, may fall largely upon domestic producers, especially if the country's exports comprise but a small fraction of world trade in the particular commodity or commodities.

Two factors are largely responsible for the use of export duties. First, they may provide a convenient source of revenue for the governments of countries in which income or property taxes are largely nonexistent or poorly organized. An export duty is relatively easy to administer since collection occurs at the points of exportation from relatively few persons. A number of Latin-American and Asiatic countries, as well as others, are heavily dependent upon export duties, and in some of them the revenue derived from this source exceeds that derived from import duties. A classic case is Chile, where until recently up to 80 per cent of governmental revenues have been derived from export taxes. As a revenue device, however, export duties are open to the criticism that yield may fluctuate widely and in highly unpredictable fashion as export volume varies. Moreover, they may be regarded as inequitable since they do not differentiate between high-profit and marginal producers.

Second, export duties may provide protection for domestic industries. This effect is achieved if the tax is upon a raw material in heavy demand in industries located abroad, and if the raw material is one in which the supplier country holds a sizable fraction of the world's supply. The duty then tends to raise foreign costs above domestic costs and thereby promotes the home industry. Examples are found in the duties levied by Norway and Sweden upon exports of wood and timber in an attempt to encourage their domestic woodworking and pulp industries.

ADMINISTRATIVE PROTECTION

The purposes served by a protective tariff are frequently served through so-called *administrative protection.* Restriction of imports is here achieved through arbitrary customs valuations, special interpretation of vague tariff nomenclature, arbitrary enforcement of sanitary and health regulations, difficult requirements as to the labeling of goods, and by other

similar means. Frequently the prevailing attitude serves to create virtually insurmountable barriers on the basis of laws which on the surface appear mild. In any event, administrative protection in many instances constitutes an "invisible tariff" of no mean proportions.

We may cite several cases involving administrative protection by way of illustration. A typical case involves the frustration an importer tends to experience when he is uncertain as to which of several possible (and, frequently, widely varying) duty rates is to be made applicable to a particular import, and when long delay tends to be involved in establishing the rate to be applied. When such uncertainties exist, importers may prove hesitant in contracting with foreign exporters. An interesting case involving labeling requirements is found in the ruling, which arose out of a decision by the United States Customs Court, that each single cigarette paper rather than each package constitutes an individual article and therefore has to be marked with the name of its country of origin. Rulings of this type tend to make it difficult for foreign exporters to prepare their goods in a fashion eligible for entry into the potential importing country. Perhaps the best known case today is the exclusion of certain beef imports by the United States as a preventive measure against the spread of hoof-and-mouth disease. The merits of this practice have long been argued pro and con. Needless to say, some Argentine cattle growers are convinced that the regulation is designed not so much to cope with the disease, which allegedly prevails in only relatively few localities, as to protect the American market for domestic beef.

SUMMARY

The advantage of free trade is that it permits an allocation of resources and manpower in accordance with the principles of the law of comparative advantage. Despite this alleged merit of free trade, the free flow of trade is today interfered with in many ways. Such deviations from a free market take many forms, including not only tariffs, but also quotas, exchange controls, state-trading operations, and various forms of international combination.

The imposition of a tariff may affect the domestic price of the dutiable commodity in any one of four possible ways: it may have no effect upon the domestic price, or it may raise the price by the full amount, by less than the full amount, or by more than the full amount of the duty. The most common effect is to raise the domestic price by some fraction of the duty, lowering the volume of imports in the process.

Tariffs may be used to reduce imports and thereby to eliminate bal-

ance-of-payments deficits, but the resultant equilibrium is achieved without getting at the fundamental cause of disequilibrium. On the other hand, new or higher tariffs in the case of a country already experiencing a surplus in its balance of payments tend to further aggravate disequilibrium.

SELECTED REFERENCES

Gordon, M. S., *Barriers to World Trade.* New York: The Macmillan Company, 1941, Chap. VIII.

°Haberler, G., *The Theory of International Trade.* New York: The Macmillan Company, 1950, Chaps. XIV-XV, XIX-XXI.

°Metzler, L. A., "Tariffs, the Terms of Trade and the Distribution of National Income," *Journal of Political Economy,* February, 1949.

Rolph, E. R., "The Burden of Import Duties," *American Economic Review,* December, 1946.

————, "The Burden of Import Duties with Fixed Exchange Rates," *American Economic Review,* September, 1947.

Samuelson, P. A., "Welfare Economics and International Trade," *American Economic Review,* September, 1938.

Taussig, F. W., *Some Aspects of the Tariff Question.* Cambridge: Harvard University Press, 1931.

7

The Tariff: II

As we look about us, we see that tariff protection has been widely resorted to throughout the world. Yet, in the previous chapter we observed that free trade is consistent with the maximization of the advantages to be obtained from the international division of labor. It appears that persuasive arguments were needed to convince countries to forego the alleged advantages of free trade. In this chapter we shall present and evaluate some of the more common arguments which have been used to promote protection. For the greater part, we shall observe that these arguments are fallacious. A few of them, however, possess some merit.

PROTECTION OF WAGES AND THE STANDARD OF LIVING

Wages vary widely among countries. We have all heard of the low wage payments of some of the countries of Latin America, Asia, and Africa, where the daily wage of common labor is reckoned practically in terms of pennies and where, even allowing for differences in living costs, the daily wage is frequently less than the hourly wage in the United States. Even among the so-called "advanced" countries wages differ greatly. For example, wages in the United States are roughly double (average) those prevailing in Great Britain, and are roughly three to

four times those of Germany and ten to twelve times those of Japan. Because of these differences, a common argument for tariffs in the higher-wage countries, and especially in the United States, is along lines that the relatively higher domestic wage level must be protected against the "ruinous competition" arising from an influx of goods produced abroad by cheap "pauper" labor. This argument holds special appeal for wage-conscious workers, and it is ideally suited as a vehicle whereby harassed producers may gain widespread popular support in their efforts to stifle the inroads of foreign competition.

There obviously is an error in this argument because year after year the output of high-wage United States labor is sold abroad in competition with the output of relatively lower-paid foreign workers. The error is that the argument does not distinguish between wage rates as such and the cost per unit of output. For example, let us assume that the wage for common labor is $1.00 per hour in the United States and that it is the equivalent of 50¢ per hour in Great Britain. Let us assume further that the production of a given commodity requires eight hours of labor effort in the United States, but sixteen hours in Great Britain. In each country the labor cost is then $8.00 per unit of output. Clearly, we must distinguish between the hourly money cost of labor and its cost in terms of output if we are to grasp the full meaning of international competition. It is the final *cost of production per unit of output* which is particularly significant from our standpoint, rather than the hourly money wage received by labor.

But, first, why do wages vary so widely from country to country? A basic explanation is found in the relative supplies of the factors of production — natural resources, labor, and capital — with which individual countries are endowed. Some countries have abundant labor relative to their supplies of capital and natural resources, whereas in others labor is the relatively scarce factor of production. In the United States, where capital and natural resources are relatively abundant and labor is relatively scarce, wages tend to be high because of the large quantity of other factors available to cooperate with labor in production. In contrast, in those countries, such as China and India, in which labor is the relatively abundant factor of production, its marginal value tends to be relatively less, and hence wages tend to be relatively low. In short, a relatively high wage level may simply reflect the favorable environment of abundant accompanying factors of production with which labor is matched, while a relatively low wage level may be attributable simply to a paucity of factors of production other than labor.

High-priced labor may actually prove to be cheap labor. Efficient

labor, working with elaborate mechanical equipment, may prove far more economical, measured in terms of cost per unit of output, than labor receiving only a fraction the wage but working under pick-and-shovel conditions. High wages do not preclude low-cost production. Rather, high wages are possible because of high productivity. Thus, the American worker receives a wage which is the envy of much of the world because his productivity in many lines of endeavor is considerably greater than that of his foreign counterpart. This does not mean that the productivity of the American worker is greater in every line of endeavor, but for a considerable range of activities such is precisely the case.

In those industries in which the total cost per unit of output is below competitive world levels, it is clear that no tariff protection is necessary. Such industries, when operating under free-trade conditions, are able to compete successfully both in the domestic market and in the foreign market. A good example is the American automobile industry. A question arises, however, as regards those industries in high-wage countries which are relatively labor-consuming, or which in any event are not sufficiently productive to offset the relatively lower wage structures found abroad. The latter industries are at a disadvantage since they are compelled through competition to hire labor at the prevailing high wage rates, while at the same time they are forced to compete for sales in the domestic market against goods produced abroad under an absolutely lower wage level. Under these conditions, the industries generally cannot long continue in business unless guaranteed a higher price through protection (or unless granted some other form of subsidy). Does this situation not then warrant protection? The answer is no. It is perfectly true that such relatively inefficient industries may be kept in business by means of protective tariffs which enable them to compete for labor at wage rates similar to those prevailing in the relatively more efficient industries, and which assure them of access to the domestic market free of foreign competition. In extending protection, however, the assistance given particular industries tends to occur at the expense of other and relatively more efficient industries. Since lessened importation tends eventually to entail lessened exportation, the effect of protection is to shift the factors of production from more efficient to less efficient production. Rather than maintaining the wage level or the standard of living, protection tends to produce opposite effects by fostering a generally poorer utilization of productive effort. We may conclude, as before, that high wages result from high productivity, not from protection. Efficient industries do not need protection in order to pay high wages; the protection of inefficient industries does not serve to raise the overall level of wages.

From the foregoing analysis it appears that a high-wage country may best protect its standard of living by specializing along those lines of endeavor in which labor-saving methods of production may be employed and in which its productivity is relatively high, importing from abroad those commodities in the production of which foreign producers enjoy a comparative advantage. The question arises, however, as to what is likely to happen to the competitive position of a high-wage country, such as the United States, if the populous low-wage countries, such as those of South and Southeast Asia, also acquire capital and technology, extended perhaps by the United States. Does not a movement toward competitive development give a high-wage country, such as the United States, grounds for imposing a protective tariff in order to safeguard its standard of living? Or, are new industries arising abroad to be freely allowed to displace specific domestic industries? On purely economic grounds, there is little to be said for tariffs on this score. Tariffs can, of course, be employed to preserve the domestic markets of particular industries when the latter are confronted with competition from abroad. The alternative, economically preferable, is to permit an adjustment within the domestic economy. The demise of the relatively high-cost domestic industries clears the way for a greater flow of relatively cheap imports, and this in turn creates an opportunity for greater exports, particularly of those products in whose production the high-wage country is relatively efficient. In short, increased production in efficient industries tends to replace the loss of production in those industries found to be inefficient under the new circumstances. Instead of an emphasis upon national self-sufficiency at any cost, the latter approach emphasizes a wider scope for the international division of labor.

A major problem during the transition period is found in the frictional unemployment which tends to arise as relatively inefficient industries give way to new and more efficient industries. Rather than to subsidize an inefficient industry through the imposition of protective levies which permanently penalize the economy, it is preferable that the transition be assisted even if some unemployment arises, since the latter problem may be dealt with through appropriate *temporary* measures, e.g., the extension of unemployment benefits, the initiation of retraining programs, and other measures designed to assist workers until they may be absorbed elsewhere in the economy, the cost of which measures may perhaps legitimately be carried at public expense. It appears economically sound to facilitate such adjustments once and for all, thereby giving the population the benefit of cheaper goods and a higher standard of living, in preference to resorting to tariff subsidization, which makes adjustments unnecessary, but which

also precludes a more efficient utilization of productive resources, thereby impairing the standard of living.

Finally, what is the case for a tariff if a country has to compete against goods produced in a foreign country having both low money wages *and* high productivity? This is the most extreme case, and is at least partially true of competition with Japan. Let us assume, simply for the sake of argument, that such a country can produce *every* item more cheaply than can a high-wage competitive country, and then let us ask the question whether a tariff wall may serve to protect the standard of living of the high-wage country. Careful analysis still indicates the merit of free trade. Even if the low-wage country is able to out-produce every competitor on every item, it nevertheless cannot produce every item equally well. The law of comparative advantage still applies: countries in which production is highly efficient gain by specializing along lines in which their relative advantages are greatest, exchanging their surplus output for goods produced under less efficient conditions in countries specializing along lines in which their relative disadvantages are smallest. A country which can produce every item cheaper than any rival does not find it to its advantage to cease trading. To do so is to deny itself the advantages arising from international specialization, and to export without also importing is equivalent to refusing payment for sales. Viewed from the standpoint of the high-wage country, operating at a disadvantage under our assumptions, an admittedly bad situation can be dealt with to best advantage if the country concentrates its effort in those fields in which its relative disadvantage is least. By so doing the country may achieve the highest standard of living possible under the circumstances.

After examining various situations, we must conclude that tariffs are injurious to a country's overall wage level and to its standard of living. The basic reason for this situation is that tariffs conflict with the utilization of productive resources in accordance with the principles of the law of comparative advantage. By shifting productive resources from more efficient to less efficient industries (or by preventing them from being shifted from less efficient to more efficient industries), tariffs tend to impede productivity and therefore to impair the overall wage level and the standard of living itself.

PROTECTION TO INCREASE EMPLOYMENT

Another common argument holds that a tariff may serve to exclude foreign goods and thereby permit an expansion in domestic production and employment. The argument has special appeal during depression

periods when every import tends to be viewed as a substitute for potential production at home. Actually the argument takes two forms: (1) tariffs may prevent the unemployment which tends to arise when cheap foreign goods are permitted to undercut domestic production, or (2) tariffs may create additional jobs in that they promote new industries or an expansion in existing industries.

As for the argument that tariffs may prevent unemployment from arising, it is not entirely irrational to support domestic output in preference to relatively cheaper imports in the hope of maintaining the domestic level of employment, provided this is the whole story. A serious omission, however, is the failure to grasp the dual nature of trade; less importation eventually leads to less exportation. Curtailment of imports as a means of maintaining domestic output and employment entails the potential loss of foreign markets, since foreigners then find it more difficult to earn the wherewithal with which to buy. In short, the greater employment in particular domestic industries tends to be at the expense of employment in other and relatively more efficient domestic industries which are able to compete not only in the domestic market but also in the export market. Any gains in total employment thus tend to occur during transition periods and are temporary at best, unless the tariff country is willing to support an export surplus through the liberal and indefinite extension of credit, a course of action which can be pursued even in the absence of tariff protection.

The second argument — that additional employment may be created through the granting of tariff protection — is equally weak. Under conditions of full employment, presumably the most that a tariff can do is to shift employment from one industry to another. The effect of tariff protection then is to give a particular industry a relative advantage over other non-protected industries in competing for factors of production. A particular producer may gain an additional domestic market as tariffs free him of competitive imports, but he acquires this market at the expense of other domestic producers. Moreover, the contraction of imports following imposition of a tariff tends to result in a loss of exports as foreigners come into possession of less foreign exchange. Since the protected industries generally are relatively less efficient than are the domestic export industries, the productive effort of the country comes to be used less advantageously.

Under conditions of less than full employment, however, a tariff may help to create additional employment, at least during a period of relatively short duration. The effect of a tariff then is to enable domestic producers to produce and market some goods previously obtained abroad,

and to do so without taking productive resources away from other domestic producers. Unfortunately, the contraction of imports following imposition of a tariff tends eventually to result in a loss of exports, either because of retaliatory action by foreign countries or simply because foreigners come into possession of less foreign exchange. Any gain in employment, therefore, tends to be short-run in nature. A certain consequence, however, both within the tariff country and abroad, is that productive effort comes to be applied less advantageously.

The basic weakness of the employment argument is that its emphasis is upon employment at any cost. Employment is not an end in itself, but is a means to the goods and services needed to satisfy human wants. If the restriction of international specialization is an appropriate method to promote greater employment, as the foregoing argument implies, it automatically follows that the complete abandonment of specialization within a country is a means to promote maximum employment. Perhaps complete personal self-sufficiency can assure employment for everyone, for long hours of labor are likely to be needed to provide even mere subsistence under such conditions. Such a situation, however, when viewed in economic terms, is hardly one to be defended. The economic merit of the make-work qualities of a tariff is placed in neat perspective in a statement made by the late Lord Keynes: "Is there anything that a tariff could do, which an earthquake could not do better?"[1]

In practice, there are other, and possibly better, ways of dealing with the problem of employment than through the imposition of tariffs. For example, domestic monetary and fiscal-policy measures, including liberal credit for investors and consumers and developmental expenditures by government, are generally regarded as being more readily defensible as media for the stimulation of employment. Such alternate schemes may serve to promote economic activity without provoking retaliation, as is likely in the case of tariffs, and without impairing living standards through a direct denial of the benefits of international specialization.

PROTECTION OF THE HOME MARKET

An old argument runs in terms of protecting the home market for domestic producers. Thus, protectionist groups in the United States have in the past proposed protection for manufacturing industries on grounds that this helps provide a market for agricultural products, and at other times they have argued that protection for agriculture helps provide a market for industrial products. The argument strongly implies that

[1] *The Nation and Athenaeum,* December 1, 1923. Cited in G. Haberler, *The Theory of International Trade* (New York: The Macmillan Company, 1950), p. 246.

domestic producers have a "right" to the home market. This notion, if carried to its logical limits, envisages the elimination of the great bulk of imports.

The home-market argument is fallacious in that it ignores the reciprocity of trade. Protection does not create additional markets, but simply substitutes a domestic market for a foreign market. If protection restricts imports, exports must sooner or later be reduced. For example, if some types of industrial output are protected, any decline in industrial imports sooner or later entails reduced exports, either of other industrial products or of agricultural products. Protection thus preserves a domestic market for some producers, but causes other producers to lose a foreign market; it assists particular producers, not all producers. The unfortunate aspect is that the protection serves to subsidize the relatively inefficient producers at the expense of the relatively more efficient producers who are able to compete successfully on their own, both at home and abroad.

KEEPING MONEY AT HOME

A flimsy but popular argument is that tariffs are needed to help keep money at home. If imports are prevented, so it is argued, an outflow of money is also prevented. In some fashion the home economy is therefore supposed to be wealthier. The basic idea is expressed in a classic remark falsely attributed to Abraham Lincoln: "I do not know much about the tariff, but I know this much, when we buy manufactured goods abroad, we get the goods and the foreigner gets the money. When we buy the manufactured goods at home, we get both the goods and the money." [2] This statement has been placed in proper perspective by Sir William Beveridge, who has said that the only sensible words in it are the first eight.[3] The idea expressed, however, is far from dead, but in fact continues to loom large in the "Buy American," "Buy British," and other similar campaigns of the modern day.

The argument embodies mercantilistic thinking of the crudest form. Its basic error stems from the belief that imports involve the loss of money. Sums paid for imports tend sooner or later to return to a country, either directly or through third countries, in exchange for exports (or investments). If such sums perchance are not used in some fashion, the situation is tantamount to the receipt of free imports. In short, money simply serves as a medium of exchange, for it is exports which actually pay for imports.

[2] Cited in F. W. Taussig, *Free Trade, the Tariff, and Reciprocity* (New York: The Macmillan Company, 1920), p. 34.

[3] *Tariffs: The Case Examined* (London: Longmans, Green & Company, 1931), p. 28.

The only real issue is whether international trade is beneficial, and the answer to this we have established earlier.

THE PROMOTION OF INFANT INDUSTRIES

The infant-industry argument constitutes one of the most valid arguments, if not *the* most valid argument, for protection, but it is perhaps also the one most easily abused. Briefly, the argument states that some industries may be economically justified, as judged by their long-run prospects for survival in a free market, but such industries often cannot successfully take hold unless protected during their early growth from the competition of established foreign producers. Because countries are at various levels of economic development, special assistance may be needed to establish industries in the younger countries; the younger countries may possess both the resources and technical skills required by new industries, but nevertheless may be handicapped in competition with countries which have already undergone similar development. It is suggested, therefore, that tariff protection be employed to "nurse" the "infant" industries to "maturity," at which time further protection is unnecessary. The net gain for the developing countries then consists of the new, economically justified industries acquired by them, a gain made possible only through means of special protection during initial periods of development.

The infant-industry argument is generally associated with the names of Alexander Hamilton and Friedrich List. Hamilton, the first Secretary of the Treasury of the United States, in his famous *Report on Manufactures,* published in 1791, urged the use of tariffs to foster the growth of manufacturing to strengthen the then predominantly agricultural economy. He felt that such tariff protection was needed to ensure the successful establishment of domestic industries in the face of the severe competition arising from the relatively cheaper imports coming from Great Britain, which country at that time held a vast industrial lead.

A further and perhaps even more persuasive version of the argument was put forth by List in his volume, *The National System of Political Economy,*[4] in which he enlarged upon Hamilton's views. List, a native of Germany, lived as a political refugee in the United States during the 1820's, where as an aspiring entrepreneur he had occasion to view first-hand the struggle of young industries against an established economic pattern. Realizing the similarity of this situation with that of Germany, where new industries too were having to compete with the output of entrenched

[4] Trans. by S. S. Lloyd (London: Longmans, Green & Company, 1922).

British producers, he became instrumental, upon his return to his homeland in 1830, in a movement for reform in tariff and related matters.

List pointed out that countries pass through stages of development in the normal course of economic evolution. At any time some countries are more developed than are others, not necessarily because the former are more favorably endowed with the physical requisites for development, but frequently simply because particular historical circumstances have made it possible for development to occur in one locale but have served to delay progress elsewhere. The country favored by early industrial development becomes the leader, and thereafter efforts at industrial development in other countries are adversely affected by competition arising in those foreign areas where production has already been established at or near optimum levels. Under these circumstances, new producers in the younger countries are generally unable to survive in the absence of protection to assure them of a domestic market for their output. Hence List argued that temporary protection is economically justified for those new industries which have the prospect of eventually competing successfully in a free market. By being temporarily freed of foreign competition, the new industries can justify their investment, acquaint themselves with market conditions, and undertake the costly trial-and-error process of discovering the methods and scale of output likely to prove most efficient. Once the producers have survived the initial period of high-cost production, tariff protection may be removed without seriously dislocating the industry. The country thereby gains a new industry, one which is not otherwise likely to arise, or the development of which is likely to be long delayed.

The promotion of infant industries, as viewed by List, did not envisage the abandonment of free trade. Rather, he felt that free trade was appropriate under many (if not most) circumstances, but that it was not appropriate for every country under all conditions. Specifically, he felt that in early stages of economic development a basically agricultural economy stands to benefit most from the unrestricted flow of imports of manufactured goods. Similarly, he felt that highly developed economies do not require protection, but stand to gain most from the wider access to markets and raw materials possible under free trade. The infant-industry argument applies particularly to economies which have the basis for development, but which cannot readily develop unless they are temporarily sheltered from the competition of the more advanced economies. Once they have effected a transition they may again practice free trade and, in fact, the scope for free trade is broadened as a result of the new productive capacity so developed.

There can be no argument with the fact that various countries are

at different stages of economic development, nor can it be denied that protection may serve to speed the growth of manufacturing in those countries which are predominantly agricultural but which have a potential for industrialization. Rather, the problem with the infant-industry argument arises in its application. First, which industries are to be regarded as logical candidates for protection? It is generally held that such industries include those likely to experience losses during early phases, though holding promise of financial solvency once they become developed, and which therefore are not likely to be established unless given protection. While this rule may suffice in theory, it proves difficult to apply in practice. Second, how much protection is warranted? List favored relatively light duties, not exceeding 25 per cent ad valorem, in order to avoid the encouragement of industries not suited to the country, and he favored the retention of such levies for no longer than twenty or thirty years at most. In short, the infant-industry argument envisages only temporary protection, and if the protected industry does not give evidence of having matured after a reasonable period, it is best to abandon it to its fate.

The most basic problem in practice centers upon the difficulty of evaluating the future prospects of an industry. Anyone contemplating entry into a new field of production can request protection for his venture by arguing that his is an infant industry. It is difficult to reject such a plea, since only experience can conclusively prove or disprove the economic soundness of an enterprise. If a venture subsequently proves economically unsound in the sense that its survival rests upon continued protection, consumers are penalized and the standard of living is needlessly impaired. Once an investment has been made, however, there arises a reluctance to permit it to go to "waste," with the result that pressures are brought for the continued protection of uneconomic enterprises. With the realization that the "infants" cannot hope to "grow up," other arguments are invoked in an attempt to justify continued protection. In short, there is an ever-present danger that protection instituted as a *temporary* device may end up as a *permanent* subsidy. In the words of one writer, "Once the Frankenstein's monster of protection is given life, it feeds upon the economic body like a cancer, rapidly outgrows the role originally assigned it, and achieves immortality!"[5]

The infant-industry argument, though essentially valid, readily lends itself as an instrument for grave abuse. Among its foremost proponents are free traders who look upon temporary protection as a means of widening the scope within which the regional division of labor may be practiced,

[5] L. W. Towle, *International Trade and Commercial Policy* (New York: Harper & Brothers, 1948), p. 327.

but in the hands of special-interest groups the infant-industry argument becomes a highly palatable appeal which paves the way for the stifling of foreign trade.

DIVERSIFICATION AND ECONOMIC STABILITY

Advocates of free trade maintain that international specialization is consistent with the maximization of output and material well-being. The counterpart of international specialization, however, is international interdependence, and in some quarters the advisability of a high degree of interdependence has come to be seriously questioned. Does not interdependence make a country vulnerable to "foreign depressions," as well as to other serious international repercussions? Does not diversification promote domestic stability? Does not tariff protection provide a means to achieve greater economic "balance," and hence stability? To answer these questions in proper perspective we need to determine, first, what factors are responsible for instability within particular economies and, second, what merit the tariff possesses as a stabilization device.

The argument that the promotion of greater self-sufficiency may serve to stabilize the economy is hardly applicable to the United States. Already highly diversified and largely self-contained, instability in the American economy cannot rightly be attributed to the indirect effects of repercussions arising abroad. Rather, such instability as exists is directly traceable to factors of a purely domestic nature, namely, to fluctuations in investment. It is futile under the circumstances to attempt by means of tariffs to exclude something which doesn't originate abroad in the first place. Efforts to stabilize a major and relatively self-contained economy, such as that of the United States, must concern themselves primarily with the investment function, not with the tariff.

The appeal for a more "balanced" economy has greater applicability in the case of the so-called *one-crop countries.* Most countries, including those of Latin America, Australasia, and Africa, are in this category, with production characteristically heavily concentrated in one or a relatively few agricultural or mineral products. The prosperity of these industries, and of the countries in which they are located, depends basically upon world market conditions. Their raw-material exports tend to experience wide price fluctuations over the business cycle, whereas prices of imported manufactures tend to be far more stable. The terms of trade thus tend to shift against the raw-material-producing countries during depression periods, causing increasing difficulty in acquiring the foreign exchange necessary to pay for vital imports. It is thus readily understandable why

these countries come to think in terms of insulating themselves against "imported depressions."

If protection can help these countries, they have good cause to employ it. The point, however, is that a system of tariffs may prove far more costly to them than the impact on occasion of repercussions from abroad. To insulate an economy of this type completely, or in large part, may serve to cushion it against foreign depressions, but it also prevents it from reaping the benefits of foreign prosperity. While the adverse effects of depressions may be felt *on occasion*, it is questionable whether it is economically wise to ensure against them by means of policies which entail the *permanent* loss of the advantages of international specialization.

Fortunately there are other and better means of dealing with the problem. While the typical, small, raw-material-producing country generally can do little on its own accord, there is wide scope for the promotion of stabilization measures within the major countries. For example, prolonged prosperity in the United States encourages high-level activity in the raw-material-producing countries whose exports find their outlet in American markets. In a very real sense, the "key" to international economic well-being is held by the major countries. Prosperity in the major countries is the first prerequisite for prosperity in the smaller countries situated on the periphery of the trading world. This does not mean that the smaller countries can do absolutely nothing on their own to stabilize their economies. Actually, selective diversification through the introduction of infant industries (assuming that it is possible to successfully screen the potential candidates for protection) may accelerate economic development and serve to widen the economic base of the latter countries. In this way, these countries may at least partially insulate their economies, and may do so without impairing productivity and the standard of living.

EQUALIZING COSTS OF PRODUCTION

Proponents of protection on occasion have suggested a tariff sufficiently high to equalize the costs of production between domestic producers and relatively lower-cost foreign producers. Pictured in this manner, a tariff is made to appear harmless and fair; the proposed levy is only enough to raise the price of an import to a level equal to the cost of domestic output, i.e., the levy merely puts domestic producers on a par with foreign producers. The argument has added appeal in that a tariff so levied allegedly serves to neutralize the foreigner's advantage in so far as his lower costs derive from the use of "pauper" labor. It is to be noted that the argument stresses the equalization of competition, an appealing proposi-

tion, not the exclusion of imports, hardly defensible on any grounds.

Close examination raises serious questions. Whose costs are to be equalized? Not all producers have the same costs in any country. In the final analysis, equalization of costs means that the tariff has to be sufficiently high to put the least efficient domestic producer on a par with the most efficient foreign producer. As long as goods continue to enter a country, this is proof that costs have not been equalized for everybody. With equality of costs as the criterion, the tariff structure tends to become completely protective, culminating in the cessation of all trade. What appears on the surface to be an eminently fair proposition turns out to be nothing short of a request for the end of importation!

An unfortunate aspect of levies to equalize costs of production is the fact that they are in the nature of subsidies for inefficiency. Consumers are in reality forced to subsidize inefficient domestic producers through the higher prices they are compelled to pay for all units of a commodity, whether imported or domestically produced. The absurdity of the argument for equalizing costs becomes quite apparent when we realize that the same result can be achieved by granting a direct subsidy to high-cost domestic producers so as to enable them to overcome their competitive handicap. It then follows that the greater a producer's handicap, i.e., the less his efficiency, the greater is the subsidy he can qualify for.

Not only are inefficient domestic producers favored at the expense of consumers, but they are favored at the expense of the country's relatively efficient export industries. The latter tend to experience a loss of foreign markets, since a reduction in a country's imports tends eventually to entail a reduction in its exports. A network of tariffs designed to equalize foreign and domestic costs of production thus yields not more production, but the substitution of less efficient production for more efficient production. The final effect is a reduction in the volume of trade, a generally less desirable allocation of productive effort, and an impairment of the overall standard of living.

TARIFFS TO PREVENT DUMPING

It is sometimes argued that a tariff is needed to prevent the dumping of goods within a country by foreign exporters. This argument for a tariff is most frequently advanced by businessmen who dislike the competition of imports sold at prices they believe to be "too low."

Dumping is said to occur when a particular commodity is offered in the importing country at a price below that prevailing in the exporting country (allowance being made for transport charges, duties, and all other

costs of transfer). Dumping may take either of two major forms. First, it may be *persistent*, occurring over a relatively long period of time as a result of different market conditions in the exporting and importing countries. Second, it may be *sporadic*, occurring only on occasion. If sporadic, it may be either *predatory* (i.e., intended to eliminate foreign competition) or *unintentional* (i.e., intended to relieve a surplus in the exporting country when domestic sales cannot readily be increased).

There is no valid case for a protective tariff to prevent persistent dumping. Relatively cheap imports, obtainable on a steady, long-run basis, are not undesirable. Buyers benefit from low-cost imports, and competitive producers can adjust to a stable flow of imports. If there is a case for excluding such imports, it rests on grounds other than that the goods are part of a process of persistent dumping.

Sporadic dumping, in contrast, may prove harmful to domestic producers, and to the economy as a whole. Such imports may serve to "ruin" domestic producers and markets during a short-run period; unfortunately, there is no long-run gain for the economy since low-cost imports do not continue indefinitely if dumping is sporadic. Clearly, there is a case for action against sporadic dumping; the question is whether a protective tariff is the weapon to use.

Actually, there is little to be said for the use of a protective tariff since it is too inflexible a device for the purpose at hand. If the alleged ill effects of sporadic dumping are to be prevented, the duty imposed must be at least sufficiently high to equalize the selling price of the dumped goods with that of domestic goods. Obviously imports must occur before the extent of the differential between import and local prices may be positively ascertained. This is the pertinent point: imports must actually occur before an appropriate duty can be tailored to prevent such imports, and by then the sporadic dumping may have ceased. An anti-dumping duty thus is tantamount to "locking the barn door after the horse is stolen." Theoretically there are ways around this dilemma. For example, a general tariff law may be adopted, under terms of which the determination of the prevailing rate may be left to administrative discretion. (Or, a system of import licensing may be utilized, again subject to administrative discretion.) This procedure has the advantage of allowing prompt action, but it is open to the criticism that administration of the highest type is likely to be required in order adequately to resist the pleas of interested parties who seek to bar competitive imports, whether these occur through dumping or otherwise. Again, a tariff sufficiently high to preclude importation under any circumstances may be adopted. This procedure is open to the criticism that it represents an outright surrender to

protection, and entails all the losses which accompany the cessation of trade. In short, sporadic dumping poses a problem, but the protective tariff does not provide an effective answer to it.

As an alternate approach, the proposal has been made that fair-trade or anti-trust laws be expanded to cover at least certain aspects of the problem of sporadic dumping. Specifically, it has been suggested that domestic firms which serve as outlets for dumped goods be made liable under such laws. It is doubtful whether such laws can provide a complete solution to the problem, but a partial solution is not beyond reach (e.g., the prevention of sales of imports dumped by cartels).

TARIFFS FOR NATIONAL DEFENSE

Even ardent free traders are inclined to allow an exception in the case of protection for those industries necessary for national defense. It is argued that if the output of an industry is needed to ensure a country's military strength, and if that industry cannot compete in a free market during peacetime, it is logical to consider it eligible for special tariff protection. Since wars do occur, and since national survival is an objective of governmental policy, countries must think in terms of military preparedness, even though they frequently can ill afford the economic cost this entails.

The question immediately arises as to which industries are vital from a national defense standpoint. In this day of total warfare, virtually any industry that produces anything normally needed in an economy can properly claim that it is "essential." Interpreted in a broad sense, therefore, military preparedness requires that a country be virtually self-sufficient. Self-sufficiency is absolutely out of the question for most countries, and even in such large and relatively self-contained countries as the United States and the Soviet Union it can only be approached, but not quite realized. In any event, the cost in terms of reduced efficiency and lowered living standards which is involved in a deliberate attempt to foster national self-sufficiency necessarily assumes enormous proportions. Commonly, however, "essential" industries are defined to include only those upon whose output the military machine is most directly dependent, e.g., those industries producing military equipment, aircraft, chemicals, precision instruments, and a few others. The extension of protection to these industries need not involve a particularly drastic reshaping of the economy, although the total cost to the economy may still prove substantial.

The fact remains, however, that there are other and perhaps better ways of handling the problem of preparedness than through the indirect

means of tariff protection. One possible alternative involves government operation of defense industries as part of a national defense program. Another possible alternative involves the payment of direct subsidies to those privately operated defense industries which stand in need of assistance. In either case, financing may be handled through general taxation, the burden falling upon the public at large. It is frequently argued that this method of financing is more likely to distribute costs in equitable fashion than if they are left to fall exclusively upon consumers in indirect and helter-skelter fashion as is the case under a protectionist policy. Financing through general taxation has an additional advantage in that it permits the public to grasp more readily the cost of the defense program and, therefore, if it so desires, to press for a revision when budget matters periodically come up for review.

TARIFFS FOR REVENUE

It is sometimes contended that tariffs offer an excellent means of raising substantial amounts of governmental revenue at relatively low cost. Harassed taxpayers under the prevailing tax system may find considerable appeal in this argument, since they frequently are inclined to look with favor upon any change which serves to shift some of the cost of government onto other domestic persons or possibly onto foreign exporters.

There is something to be said in favor of a revenue tariff when used under particular circumstances. For example, a relatively low rate of duty upon a commodity of widespread domestic consumption, the entire supply of which is imported, ordinarily does not lead to a misallocation of domestic productive effort, nor is such a duty likely to prove seriously inequitable as between groups of persons within the country. Moreover, the duty is easy to collect, and a series of such duties may yield considerable revenue. There is danger, however, that the indiscriminate enactment of tariffs on the pretext of raising revenue may lead to abuse. A tariff ostensibly adopted for revenue purposes may later be broadened and heightened to provide protection for direct competitors or for those producing close substitutes. In this event, as we have earlier observed, the tariff serves to aid particular domestic producers at the expense of consumers, while providing private profit rather than government revenue.

Revenue tariffs have been adopted in many countries, and some of them have come to rely heavily upon this source of revenue. For example, the governments of most Latin-American countries are heavily dependent upon customs receipts, and in some of them such receipts amount to over one-half of all government revenues. The tax structures of these countries

are frequently not highly developed, so that import duties come to be viewed as the "old standby" in the revenue system. Great Britain has in recent years deviated far enough from free trade to institute a system of relatively light revenue tariffs. Duties have been largely confined to those imports which have no domestic counterpart and which enjoy widespread domestic consumption. Important examples include duties upon tea and sugar. In the United States, customs receipts today total only about 1 per cent of all federal revenues. A century ago, however, customs duties constituted this country's leading single source of revenue, yielding almost 99 per cent of total revenues. The decline has been in relative terms, rather than in absolute amounts, and may be attributed in large part to the increased importance of alternate revenue sources, particularly of personal and corporate income taxes. To some extent, also, an increase over the years in the rates of duty has served to yield protection rather than revenue.

TARIFFS FOR BARGAINING

It is sometimes argued that if a country has a protective tariff it is in a position to use this tariff as a bargaining device to get another country to grant a tariff concession, but that if it has no tariff, or only a revenue tariff, it has nothing to offer in exchange for a tariff concession which may open foreign markets for its goods. Therefore, the argument continues, a country needs to acquire protective tariffs in order that there can be a basis for negotiation with other countries in an attempt to force an all-around reduction of tariffs.

This argument may be easily abused. Advocates tend to picture themselves as free traders at heart; a tariff increase, they insist, is really only temporary and is scheduled to be revoked when foreigners agree to make offsetting concessions, the final result being freer trade. Free trade, so pictured, is promoted through temporary restriction. If the process works in this manner, there is much to recommend it. The danger, however, is that once tariffs are increased, vested interests may be able to forestall their subsequent reduction, so that what was intended to be temporary protection in reality becomes permanent protection. A preferable approach perhaps is for a country to promise not to raise rates, provided others agree to a reduction.

Protective tariffs may also be adopted as a retaliatory measure against the erection of trade barriers by other countries. Such a policy may serve to inflate a country's ego, but it does not make good economic sense. Protection tends to hurt the country adopting it as well as the foreign power, and it does so by curtailing the benefits arising from international

trade. Or, to put it differently, reducing a country's tariffs admittedly helps other countries by opening markets to them, but it also helps the first country through promotion of its exports. As we have seen, the latter is a logical consequence since payment for a greater volume of imports in turn leads to a greater volume of exports. In overall terms, specific industries may experience adverse effects as protective tariffs are removed, but the economy as a whole stands to benefit from such action.

WHY TARIFFS PERSIST

Protection is vulnerable on grounds that it interferes with international specialization, and hence prevents potential gains from trade from actually accruing to individual countries. As appears evident through an examination of specific arguments, protection is economically sound in only limited cases. Even then, in almost every instance, there are alternate and better ways of attaining the same end. If so little can be said for protection, why do countries cling to it?

The answer to this question is found basically in the notion of self-interest as conceived by particular persons or groups, or by countries as a whole. First, free trade may conflict with personal self-interest as seen through the eyes of particular persons or groups. It is hard to imagine a situation in which any number of domestic producers, confronted by lower-priced competitive imports, uncomplainingly acknowledge their relative inefficiency and offer to step aside in the interests of the higher standard of living offered by free trade. Rather, the usual situation is that when a particular industry is adversely affected through competitive importation, someone proposes a tariff on the strength of any one or more of a number of made-to-order arguments. Support for tariff assistance is almost always forthcoming from various groups, each of which in some manner identifies its own welfare with that of the distressed industry. Laborers value their jobs in the industry, the community does not wish to lose the industry, stockholders have money invested in the industry, dependent firms have come to rely upon the business they do with the industry, and so it goes. Invariably protectionists can present facts and figures referring to a *specific* industry or group of people whose immediate welfare is directly at stake. Against their pointed appeals, what chance have free traders who talk in terms of promoting the *general* welfare or the national interest? In all this the consumer population comprises a bloc which has every reason to question the wisdom of protection; it is consumers who are directly concerned in the matter of prices. Consumers, however, tend to be more poorly organized and less vociferous than producers, to

say nothing of the fact that consumers may also be laborers, businessmen, or investors, and thus possibly suffer from a "divided loyalty" on the tariff issue. Of course, "talk is cheap" and tariffs come into being only because legislative bodies are willing to put their stamp of approval upon them. As applied to the United States, we need to recall that members of Congress who pass upon tariffs are elected locally, not nationally, and they may thus seal their political doom by disregarding home interests. The hopes of sectional interests, which might come to naught under other circumstances, are readily translated into law through the legislative pastime of log-rolling. In consequence, the drive for protection proceeds largely unimpeded, even though the restrictions thus imposed tend to favor particular producers at the expense of other producers, and at the expense of consumers in general.

Second, governments not only are prone to pay heed to particular pressure groups (which may manifest a self-interest they often truly believe to be synonymous with national welfare), but they are concerned directly with the national self-interest. One possible national objective is self-sufficiency, independence being capable of expression in both political and economic terms. Major countries on occasion attempt to foster national self-sufficiency; classic historical examples include Nazi Germany and Soviet Russia. Smaller countries, too, often become obsessed with the alleged virtues of national self-sufficiency. The latter countries, frequently "backward" and poor, seek to vent their national aspirations, very commonly under the guise of economic development. In addition to these motives, countries commonly attempt to foster their self-interest through domestic planning, the notion being that a country has a right to direct its destiny rather than to leave this to the chance forces of international competition. It is especially significant that the Great Depression witnessed the erection of a network of trade barriers, and that the fear of adverse international repercussions continues to provide the rationale for impediments to the free flow of trade.

There is another reason why tariffs persist: once protection is adopted, it becomes difficult to revert to free trade. While it is to be expected that those who have come to enjoy the fruits of special treatment are inclined to resist vigorously the withdrawal of tariff supports, there is more to the problem than what can rightfully be attributed to the self-seeking motives of particular groups. Once a country has had a network of protection over a period of years, its entire economic structure comes to be "warped" by the "artificial" environment prevailing behind the sheltering tariff wall. Tariffs protect not only those industries on whose behalf they were first instituted, but also newer industries which have arisen in con-

sequence of protection. If protection is suddenly withdrawn, what is likely to happen to these industries, and to the economy as a whole? This question is not unlike an inquiry as to what is likely to happen to vegetation carefully nurtured within a hothouse if the protective structure is suddenly removed. The sudden and complete removal of protection undoubtedly leaves some industries largely unaffected, since there are some industries which never required protection in the first place; other industries, however, tend to be affected, more or less, depending upon the extent to which the country has been protectionist. The impact upon the economy as a whole may well prove severe, creating economic, political, and social problems of gigantic proportions. It is for this reason that the supporters of free trade, though critical of protection, generally do not advocate an overnight return to free trade. As a concession to practical politics and economics, their emphasis is necessarily placed, first, upon halting the spread of protection, and second, upon the gradual removal of existing tariffs, either in easy stages or one at a time. In short, free trade in its absolute form is today largely an academic question, but it does serve as a useful point of reference for the formulation of long-run national policy. To many it serves as an ideal, if not an immediate objective.

SUMMARY

The argument for free trade may be stated in one sentence: the free interchange of goods tends to lead to an allocation of productive effort which yields maximum output for effort expended. In contrast, the arguments for protection are many and varied, but this does not mean that their merit overshadows that of free trade. Some of the tariff arguments are definitely fallacious, while others appear to be valid, in greater or lesser degree. It is frequently true in the latter instances, however, that the avowed gains from protection may be better achieved through other means.

Despite the intellectual flaws of most protectionist arguments, protection continues to prevail. This situation exists largely because support for protection is not ordinarily won on intellectual grounds, but rather on emotional grounds. The emotional appeals generally stress self-interest in one form or another.

SELECTED REFERENCES

*Beveridge, Sir William, *Tariffs: The Case Examined.* London: Longmans, Green & Company, 1932.

°Haberler, G., *The Theory of International Trade*. New York: The Macmillan Company, 1950, Chaps. XVI-XVII.

Harrod, R. F., *International Economics*. New York: Harcourt, Brace & Company, Inc., 1947, Chap. IX.

List, F., *The National System of Political Economy*, Trans. by S. S. Lloyd. London: Longmans, Green & Company, 1922.

Taussig, F. W., *Free Trade, The Tariff, and Reciprocity*. New York: The Macmillan Company, 1920.

————, *Selected Readings in International Trade*. Boston: Ginn and Company, 1921.

°————, *Some Aspects of the Tariff Question*. Cambridge: Harvard University Press, 1931.

8

Import Quotas

In addition to the restriction through tariffs, imports may also be controlled by means of quotas. Like tariffs, quotas represent an old form of trade restriction, dating at least from mercantilist times. They have enjoyed a considerable degree of popularity in recent decades, especially during the depression years of the thirties and the years following World War II.

THE NATURE AND PURPOSE OF QUOTAS

Import quotas (sometimes referred to as "quantitative restrictions") most commonly take the form of absolute limits upon the *physical volume of particular imports* which may enter a country during a specified time period. Quotas of this form are akin to tariffs, and may, in fact, be used as substitutes for them, or as supplements to them. Like most tariffs, quotas of this form are imposed for the protection they give domestic producers.

In a growing number of instances, however, especially during the past two decades, quotas have come to be used by countries as a means to confine the *total value of importation* within certain predetermined limits. Restrictions of the latter type generally occur through the licensing of imports, and are used in connection with systems of exchange control.

When quotas take this form, they most frequently are used to assist in the promotion of balance-of-payments equilibria, although protection may also result as a by-product.

EFFECTS: QUOTAS VERSUS TARIFFS

A quota, in limiting importation, tends to raise the price of the commodity to which it applies. While this tends to be true also of a tariff, the effects of a quota differ in some important respects from those of a tariff. In its effect upon the physical *volume* of imports, a tariff, no matter how high, need not prove absolutely protective. Any dutiable commodity theoretically remains free to enter a country upon payment of the duty. The exact amount of the commodity which does enter depends entirely upon the conditions of supply and demand (and price) in the domestic and foreign markets. A quota, in contrast, limits importation to a fixed amount, irrespective of supply-and-demand conditions (or price) in the domestic or foreign markets.

In its effect upon *price*, a tariff, as we saw in Chapter 6, may leave the price of a dutiable commodity unaffected, or it may raise price by an amount less than, equal to, or greater than the duty. In event of a price change following the imposition of a duty, the increase in most instances tends not to exceed the amount of the duty; moreover, in those instances in which the price increase does exceed the amount of the duty, the increase tends to be held to an amount bearing some relatively close relationship to the duty since more of the commodity can always be imported as long as importers pay the duty. The range within which price will fall is pretty well circumscribed. The price change following the imposition of a quota may, in contrast, prove far more unpredictable. A quota system places a limit upon the volume of imports, after which the determination of price in the domestic market is left to the interaction of supply-and-demand forces. While the price effect is related to the degree of restrictiveness of the quota (i.e., to the supply of the commodity) and to the nature of the demand (i.e., to the elasticity of demand for the commodity), the various combinations of circumstances result in a price falling somewhere within a relatively wide range of possible prices. In the exporting country, the price either remains constant or declines.

The general conclusion may be drawn that, if a tariff is imposed, a fairly good idea may be had as to the probable effect upon price, but considerable question tends to exist as to the probable volume of importation; in contrast, if a quota is imposed, considerable question may be raised as to the probable effect upon price, but there tends to be a high

degree of certainty as to the volume of importation. Despite these points of contrast, tariffs and quotas are capable of being used interchangeably; it is *possible* to accomplish with a quota everything which may be accomplished with a tariff, and vice versa. In order to ascertain what quota action will yield the same result as a given tariff, or vice versa, it is necessary to have full information concerning the relevant supply-and-demand conditions prevailing.

Finally, those persons or firms fortunate enough to qualify as importers under a quota system are placed in a monopoly-like position and are able on occasion, in consequence of this position, to garner so-called "quota profits." These profits arise in addition to the added profits which ordinarily accrue to domestic producers following the curtailment of competitive imports. Profits akin to quota profits do not arise under a tariff system since in the latter case anyone remains free to import in unlimited amounts if he is willing to pay the duty.

TYPES OF IMPORT QUOTAS

We may distinguish five major types of import quotas: (1) the tariff quota, (2) the unilateral quota, (3) the bilateral quota, (4) the mixing quota, and (5) import licensing. The first four of these are almost always devised in terms of a limitation upon the physical volume of imports, while the last named — import licensing — is most frequently handled in terms of a limit upon the total value of imports and is generally used in connection with the administration of exchange control.

The Tariff Quota

Under a tariff quota, imports of a commodity up to a specified volume are permitted to enter a country at a special low rate of duty (or free of duty), but any imports in excess of this minimum volume are permitted to enter only through payment of a higher rate of duty. The tariff quota thus combines the features of a tariff with those of a quota. Examples include the treatment accorded by the United States to imports of petroleum, butter, tobacco, and other products.

A tariff quota has the advantage of being flexible. A specified quantity of a commodity is allowed to enter on especially favorable terms; additional imports are not excluded, but remain free to enter under somewhat less favorable terms. A major drawback is found in the fact that the urge to get imports in under the initial minimum rates tends to bring a rush of imports during the early part of the quota period, thereby tending to produce greater price fluctuations than otherwise likely to prevail.

The Unilateral Quota

Under a unilateral quota, a single country undertakes to fix an absolute limit upon the quantity of a commodity eligible for import during a given period. Such a quota may be formulated either in *global* terms or on an *allocated* basis.

Under a global quota, imports are admitted from any country or countries up to the full amount of the quota. This procedure is subject to a number of criticisms, probably the most significant one being that the system tends to operate against the smaller or less well-organized supplier countries as importers follow the simple course of obtaining the full quota from a relatively few major supplier countries. This tends to be the case when there is no clear-cut price advantage, or other reason, to induce importers to purchase from the smaller supplier countries.

A second procedure involves the use of an allocated quota, under which the quantity of imports allowable under the global quota is apportioned among the various supplier countries. The usual procedure is to assign quotas whose size bears some relation to the volume of trade in some previous base period. Unfortunately, this has the effect of freezing trade in terms of some arbitrary pattern, and the approach, however well-intentioned, may therefore prove highly unfair to particular supplier countries. For example, if the base period chosen is one during which a particular supplier country experienced an unusually low volume of exports (e.g., because of a crop failure) or is one which preceded pronounced population or industrial growth in the supplier country, the assignment of a quota based thereon tends not to apportion allowable imports according to the supplier country's present importance. It is necessary, therefore, to exercise extreme caution in the selection of the base period if the allocated quota is to prove representative and non-discriminatory.

The Bilateral Quota

A bilateral quota is arrived at through negotiation between the importing country and a particular supplier country, or between the importing country and export groups within the supplier country. Once such an agreement is ratified by the governments concerned, the importing country can, and frequently does, assign quotas to other countries in accordance with their relative importance during a previous base period.

The strongest argument in favor of a bilateral quota is that it is not arrived at unilaterally, and hence tends ordinarily to be less arbitrary than a unilateral quota. The criticism may be made, however, that when

export groups are a party to the negotiation process, the quota agreement tends to reflect to an unwarranted extent the special interests of particular, and generally well-organized, commercial groups. A common result, therefore, is a rationalization of the export market and the channeling of abnormal quota profits to special groups.

The Mixing Quota

Numerous countries have in effect regulations which require producers to utilize domestic raw materials, up to a certain proportion, in the production of a finished product. These regulations, sometimes referred to as "linked-usage" regulations, have a quota-like effect in that they serve to limit imports to some relatively fixed ratio of particular domestic production. For example, prewar Germany required that all flour milled within the country contain domestic wheat up to a certain proportion of total content, and that flour used in bakery products consist of a mixture of potato and wheat flour combined in certain proportions. Similarly, Great Britain requires millers to mix domestic wheat with imported wheat in certain proportions. Other well-known cases, past or present, include the admixture of synthetic fibers with wool, alcohol with gasoline, domestic beet sugar with imported cane sugar, domestic with foreign tobacco, and chicory with coffee.

Mixing regulations generally have either or both of two objectives. First, they may be adopted in an attempt to assist domestic producers. In requiring domestic raw materials to be combined with imported raw materials, a market is assured particular domestic producers, even though their output may be more costly and of poorer quality than competitive imports. Second, they may be adopted in an attempt to curtail imports and thereby to conserve relatively scarce foreign exchange. Whatever their intended purpose, however, mixing regulations are open to the criticism that they make for a poorer utilization of the world's resources and manpower, and that they generally result in higher domestic prices or in poorer quality products.

Import Licensing

The effect of a quota is also achieved through the licensing of imports. Under this system, prospective importers are obliged to obtain a license from the proper authorities, and this license then either validates the use of foreign exchange in payment for imports or authorizes the purchase of foreign exchange for use in payment for imports. Import licensing thus represents an indirect restriction upon importation; it restricts not im-

ports as such, but the use of the foreign exchange needed to pay for imports.

Little used prior to World War II, import licensing has been a leading type of quantitative restriction during the postwar period. This popularity is attributable to two major factors. First, import licensing allows a high degree of flexibility in the restriction of imports. The issuance of licenses is an administrative procedure and hence may be readily adapted to fit changing circumstances. Second, import licensing is a device by means of which a country may control the demand of its residents for relatively scarce foreign exchange. For example, during the post-World War II years, when many countries experienced shortages of dollar exchange, import licensing came to be widely practiced as part of an effort to curtail imports from the dollar area,[1] thereby to curtail the outflow of dollars needed to pay for such imports.

When the purpose of import licensing is that of allocating relatively scarce supplies of foreign exchange, either of two basic methods is followed. One method is to set up a list of categories indicating "decreasing essentiality." Licenses are then granted to include as many uses of varying and decreasing importance as can be met from the available supplies of foreign exchange. A second, and less stringent, method is to list those commodities requiring import licenses, but to make no reference to any order of priority. The total amount of importation is then determined simply by the amount of foreign exchange currently available. In some countries licenses are issued sparingly since they carry with them the right to acquire foreign exchange. This is the practice in Great Britain, and in several other European countries. In other countries the receipt of a license gives no assurance that foreign exchange may be obtained, but merely authorizes the recipient to purchase foreign exchange if it is available. The latter is the usual practice in Latin America. The prevalence of import licensing, used either singly or in conjunction with exchange control, is indicated by material summarized in Table 18. Shown there are the regulations in effect (in 1954) in a number of major countries for the control of imports from the United States or of imports payable in United States dollars.

Import licensing is admittedly a powerful device for controlling the quantity of imports, either of particular imports or of imports as an aggregate. The system, however, has its shortcomings, one of which bears

[1] The most important country in the so-called "dollar area" is the United States. Included also are Canada and the following countries in Latin America: Bolivia, Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, and Venezuela.

Table 18

Foreign Control Regulations Applying to Imports from the United States, Selected Countries [1]

(May 1, 1954)

Country	Is import license necessary?	Is exchange permit required?
Argentina	No	Yes
Australia	Yes	Import license carries right to foreign exchange.
Austria	Yes	Yes
Belgium-Luxembourg	Yes	No separate permit required.
Brazil	Yes	No; exchange for imports is sold at auction.
Canada	No	No
Chile	Yes	Yes
Cuba	No	No
Czechoslovakia	Yes	Import license carries right to foreign exchange.
Denmark	Yes	Yes
Egypt	Yes	Yes
France	Yes	Import license carries right to foreign exchange.
Germany, Fed. Rep.	Yes	Yes
India	Yes	Yes
Italy	Yes	No separate permit required.
Mexico	Yes	No
Netherlands	Yes	No separate permit required.
New Zealand	Yes	Import license carries right to foreign exchange.
Pakistan	Yes	Yes
Peru	No	No
Spain	Yes	Yes; special exchange rates are fixed for many import products.
Sweden	Yes	No separate permit required.
Switzerland	No	No
Turkey	Yes	Yes
Union of S. Africa	Yes	Import license carries right to foreign exchange.
United Kingdom	Yes	Yes
Uruguay	Yes	Import license carries right to foreign exchange.
U.S.S.R.	Yes; importing Government agencies are responsible for securing own permit.	Yes; all exchange allocated by U.S.S.R. State Bank upon receipt of import license.
Venezuela	No	No

[1] "Yes" indicates that all or substantially all items are subject to control; "no" indicates that no imports, or only relatively few, are subject to control.

Source: U. S. Department of Commerce, *Foreign Commerce Weekly*, Washington, June 7, 1954, pp. 10-12.

mention here. Since the licenses are ordinarily not freely obtainable, any practice which makes them available to particular persons, to the exclusion of others equally eligible, is eminently unfair. The restriction of importation tends to place a premium upon imports, and this results in monopoly profits for those who happen to hold import licenses and, with them, the "privilege" of importing. One way around this situation is to have the government auction available licenses to the highest bidders. Competition for the licenses then tends to give the government the monopoly profits arising from the monopolies it has itself created. This procedure has never been adopted in the form stated, although minor steps in this direction have been attempted.

THE CASE OF SUGAR

The policy of the United States toward sugar, one of the leading primary commodities entering international trade, may serve to illustrate how one type of quota operates. In formulating its sugar policy, the United States has had to reckon with a number of economic, political, and historical factors. First, the American source of supply is partly domestic and partly foreign. Sugar beets are grown in several western states and sugar cane is grown in Florida and Louisiana; additional supplies of cane sugar are obtained from offshore American possessions, e.g., Puerto Rico, Hawaii, and the Virgin Islands; and some cane sugar is imported from foreign areas, especially from Cuba, the world's leading sugar producer. Costs of production vary widely among these areas. Specifically, domestic beet sugar generally proves more costly to produce than does mainland cane sugar, although both are at a competitive disadvantage against cane sugar grown in Puerto Rico, Cuba, and in some other offshore areas. Second, mainland producers are protectionist-minded. They rest their case, in part, on national defense, their argument being that an assured supply of sugar near at hand is vital in event of war.[2] For this reason, and presumably also for purely political reasons, the mainland producers are, and have long been, favored by the government. Special assistance accorded them includes restrictions upon the competitive importation of cane sugar, as well as outright subsidies during relatively recent years. Third, the relatively low-cost cane sugar of Puerto Rico and Hawaii is allowed to enter the mainland market free of duty since these territories are within the American customs area. Fourth, the relatively efficient

[2] This argument appears very weak, particularly in view of the fact that during World War II, when mainland sugar producers were largely free of foreign competition, mainland sugar output actually fell some 20 per cent below prewar, the result basically of a shift to relatively more profitable crops or pursuits.

and large-scale foreign producers, such as those located in Cuba, desire entry into the American market, thereby creating a problem of competition for domestic producers, both for those on the mainland and for those in American offshore areas. Finally, for historical reasons dating from the time of the Spanish-American War, the United States accords Cuba special treatment in tariff and quota matters, resulting in that country's being set apart from other foreign countries. Similarly, the United States is today committed to a policy of leniency toward imports from the Philippine Republic, a carry-over from the days when the latter country was under United States jurisdiction. The problem for the United States in devising a sugar policy is one of how to reconcile these various interests and commitments, while still assuring the ultimate consumer of fair treatment.

The sugar policy of the United States as now constituted has three main facets: (*a*) import quotas, (*b*) import duties, and (*c*) domestic subsidies. The quota provisions applicable today are contained in the United States Sugar Act of 1948, renewed (and amended) in 1951 for a four-year period extending through December, 1956. The major provisions of this act, and related factors (e.g., tariff and subsidy provisions), may be summarized as follows:

(1) Total domestic consumption requirements are determined each year by the Secretary of Agriculture following hearings open to both domestic producer and consumer groups. While this procedure appears entirely fair, it nevertheless is subject to the criticism that the figure selected is an arbitrary one and tends to be on the low side since the consumer voice is frequently not very strong. For the calendar year 1954, a consumption figure of 8.2 million tons was arrived at.

(2) Once the domestic consumption requirement is established, a decision is made as to what portion of this amount is to be allotted each of three groups: (*a*) mainland producers (i.e., both the domestic beet-sugar growers and the cane-sugar growers of Florida and Louisiana), (*b*) offshore domestic producers (i.e., the cane-sugar growers of Puerto Rico, Hawaii, and the Virgin Islands, who are domestic producers within the meaning of the law), and (*c*) foreign producers. Again the decision is an arbitrary one, and one in which it is to the self-interest of the domestic producers (mainland and offshore) to obtain as large an allotment as possible, to the exclusion of foreign producers. For the calendar year 1954, these quotas (or prorations) for domestic producers were set at the following levels: domestic beet sugar, 1.8 million tons; mainland cane sugar, 0.5 million tons; Hawaii, 1.1 million tons; Puerto Rico, 1.1 million

tons; and the Virgin Islands, 0.01 million tons. The Philippine Republic, for all practical purposes still a part of the United States customs area (although gradually being shifted to the status of a "foreign" area), received a quota of 1.0 million tons. The "balance" in excess of these amounts, approximately 2.8 million tons, was the quota granted foreign producers.

(3) The aggregate of allowable sugar imports from foreign countries is next apportioned among individual countries in accordance with a formula. The procedure is to allocate quotas to individual countries in proportion to the volume of their sugar shipments to the United States during some earlier base period. The quota arrangement, as applied to imports for 1954, gave Cuban producers the right to fill 96 per cent of the above allowable sugar import quota, the other 4 per cent being allotted to various other countries.

The procedure employed in allocating allowable sugar imports to foreign producers is open to criticism on grounds that the selection of a base period reflects an arbitrary decision, and readily invites conscious discrimination against particular countries whose exports to the United States may have been unusually low during the particular years chosen to serve as a point of reference. The base period utilized by the United States in assigning sugar quotas (United States sugar imports during 1931-33) has the effect, for example, of favoring Cuba over, say, the Dominican Republic, with the result that the two virtually adjacent countries now market their sugar output in widely separated localities, Cuba largely in the United States and the Dominican Republic almost exclusively in Great Britain.

(4) The system of import quotas is the major instrument used in protecting the home market for domestic sugar producers. In addition, a duty is levied upon sugar imported from foreign countries. Shipments by offshore domestic producers, located in Puerto Rico, Hawaii, and the Virgin Islands, are not subject to duty, but shipments from foreign countries are dutiable. A uniform specific rate of duty, amounting to 62½¢ per 100 lbs. (1954), is applied, with two exceptions. Cuba has since 1902 been accorded preferential tariff treatment amounting to a minimum of 20 per cent below the so-called "full duty" applicable to sugar imports originating in other foreign countries. During 1954, the effective rate on sugar imports originating in Cuba was 50¢ per 100 lbs. Similarly, sugar imports from the Philippine Republic are now entirely duty free, and are scheduled to remain so until July 1, 1956, at which time a rate 15 per cent that of the Cuban rate is scheduled to go into effect.

(5) Domestic sugar producers are thus protected by both a quota and a tariff. In addition, mainland growers of sugar beets and sugar cane, and offshore domestic growers of sugar cane, have in recent years received United States Government subsidies under this country's farm program. General revenue is raised by the Government by means of a processing tax on sugar, and payments are made to growers from the general funds of the Treasury.[3]

SUMMARY

A quota, like a tariff, may be used to restrict imports. Despite some significant differences between them, quotas and tariffs are capable of being used interchangeably; it is possible to devise a quota to yield the identical effects of a given tariff, and vice versa. In practice, quotas are frequently used either as substitutes for, or as supplements to, tariffs.

Five main types of quotas may be distinguished: the tariff quota, the unilateral quota, the bilateral quota, the mixing quota, and import licensing. The latter — import licensing — has come to represent a leading type of quantitative restriction, especially since World War II. Its popularity rests largely upon the control it gives a country over the use of its available supplies of foreign exchange. It is used largely in conjunction with exchange control.

SELECTED REFERENCES

°Gordon, M. S., *Barriers to World Trade*. New York: The Macmillan Company, 1941, Chap. IX.

°Swerling, B. G., "A Sugar Policy for the United States," *American Economic Review*, June, 1952.

U. S. Department of Agriculture, *The United States Sugar Program*, Washington, July, 1953.

[3] The revenue raised by means of the processing tax is not specifically earmarked for payments to growers. Such a procedure was held by the Supreme Court to be unconstitutional in the decision rendered in the case of the Agricultural Adjustment Act during early New Deal days. The procedure in the case of sugar is to raise revenue for "*general* purposes" and to pay growers from "*general* funds." The economic effect may be precisely the same, but there is a vast difference in legal (constitutional) terms.

9

Exchange Control: I

Some reference to exchange control has been made in previous chapters, but in view of its significance in the present-day world a fuller analysis appears justified. This chapter accordingly treats some of the historical and theoretical aspects of exchange control. The succeeding chapter summarizes basic features of the exchange-control systems of two leading countries.

THE MEANING OF EXCHANGE CONTROL

Exchange-control systems in existence today have one thing in common: the rationing of foreign exchange — to a greater or lesser extent, depending upon particular circumstances. In virtually every instance, the rationale for such rationing is that, at the prevailing rate of exchange, the supply of foreign exchange is not replenished at a pace equal to the current demand. In the interests of maintaining a stable exchange rate, the exchange-control authority (the central bank, treasury, or specially constituted agency) customarily acts to mobilize the supply of foreign exchange and to allocate the relatively scarce supply, in accordance with certain arbitrary criteria, among those demands the fulfillment of which are deemed most vital to the country.

Under exchange control, the foreign exchange held by a country, or currently accruing to it (sometimes only some fraction of current receipts),

is brought directly under the control of the exchange-control authority. It is customary for a country to adopt provisions making it illegal for exporters and others receiving foreign exchange to sell any, or some part, of this foreign exchange to the highest bidder in an open market; rather, such foreign exchange (all or in part) is required to be exchanged (sold) for domestic currency through institutions (e.g., commercial banks) authorized by the central agency. It is generally necessary to implement the overall regulations with a host of detailed provisions designed to eliminate evasion.

In restricting the demand for foreign exchange, the usual practice of the exchange-control authority is to classify various types of potential demand into categories in the order of their presumed essentiality. Each category may then be dealt with in a separate and distinct manner. For example, no foreign exchange may be allowed for a speculative exodus of capital; only a relatively small amount of foreign exchange per person during a specified time interval may be allowed for foreign travel; little or no foreign exchange may be allowed for luxury imports; foreign exchange may be granted in relatively generous fashion if needed to finance imports of foodstuffs or of raw materials essential in domestic industry, etc. The precise treatment accorded various categories of demand varies from country to country, and is subject to occasional change within individual countries. In some countries a system of import licensing is employed in conjunction with exchange control in order to control the volume and type of imports giving rise to foreign-exchange demands.

The nearer the exchange-control authority comes to holding an absolute monopsony-monopoly position in the exchange market, the more effective its power of control tends to be. If the central authority is the sole buyer (monopsonist) and the sole seller (monopolist) of foreign exchange, it possesses wide discretionary power in the determination of the buying and selling prices of foreign exchange, the uses to which it may be put, who may acquire it, the countries in which it may be used, etc.

Finally, it is well to understand that under exchange control the day-to-day business of buying and selling foreign exchange is ordinarily handled by private exchange dealers, largely the exchange departments of commercial banks. The latter, however, act in accordance with regulations laid down by the central authority, so the really important consideration is not who performs the physical task of buying and selling foreign exchange, but rather who makes the basic decisions prescribing the conditions of purchase and sale. Under exchange control, these decisions are centralized and governmental in nature, and represent deliberate policy rather than the chance results of free-market forces.

THE HISTORY OF EXCHANGE CONTROL

Prior to World War I, there was little need for exchange control. Operating under the international gold standard, individual countries were prone to rely primarily upon the automatic adjustments of the price-specie-flow mechanism for the maintenance of stability in their exchange rates and equilibria in their balances of payments. When, on occasion, the international gold standard failed to yield acceptable results, the usual procedure was to deviate temporarily from the "rules of the game" (e.g., through resort to independent central-bank action: changes in interest rates, loan policies, etc.) in order to ease, or delay, the adjustment process. From an overall standpoint, however, the international gold standard was an automatic standard, and there was little room under it for any widespread system of governmental controls.

During World War I, in consequence of the disruption in world trade, a number of countries instituted exchange-control measures. These measures were regarded as temporary at the time, and were quickly terminated upon cessation of hostilities. It was not until after the onset of the Great Depression, and after the formal rejection of the international gold standard by various countries, that exchange control assumed major proportions. Numerous countries instituted systems of exchange control especially during the years 1931-33 in an attempt to cope with their rapidly mounting balance-of-payments difficulties under the prevailing depression conditions. Basically, these difficulties had their origins in three major developments. First, an effect of the depression was to produce distortions in world trade. The depression did not strike every country at the same time, nor with equal severity, with the result that imbalances became legion in international accounts. As the contraction of world trade proceeded, some countries suffered substantial and growing deficits in their balances of payments. Second, the depression took a heavy toll in its effect upon international lending. As economic contraction proceeded in the United States and Great Britain, the leading creditor countries at the time, the flow of long-term capital from them to other countries came to a virtual standstill. Individual countries, especially in continental Europe and Latin America, long geared to an inflow of capital, found their balance-of-payments difficulties greatly compounded by this decline in foreign lending. Third, unsettled political and economic conditions during the depression years served to foster "*capital flights,*" i.e., capital movements motivated predominantly by a fear of domestic developments rather than by the inherent attractiveness of foreign opportunities. Some

countries, already experiencing deficits in their balances of payments, found that they could ill afford, in addition, to submit to the substantial exchange losses arising through such outflows of capital.

As particular countries began to experience marked (and frequently growing) deficits in their balances of payments, they were confronted with the basic problem of how, short of further domestic deflation, to reconcile (1) the need to meet external payments-claims with (2) the maintenance of exchange rates at existing levels. During the early stages of the depression, few countries were disposed to relinquish exchange stability at existing levels without at least first having a try at other corrective devices. Exchange depreciation was considered to have three major disadvantages under the circumstances: (1) its worsening effect upon the terms of trade (i.e., a greater volume of exports comes to be needed to pay for a given volume of imports), (2) its potential inflationary effect (since depreciation cheapens exports and hence increases their volume, and increases the cost of imports and hence lessens their volume), and (3) its effect in increasing the cost of servicing or repaying obligations owed abroad (when the latter are expressed in terms of a non-depreciated currency). The remaining alternative open to countries was to attempt to "force" a balance in their international accounts through some form of restriction upon transactions leading to demands for foreign exchange. This was the role assigned to exchange control; the latter represented a way for a country to confine foreign-exchange demands within limits of foreign-exchange receipts.

It was against this general environment that exchange control came to be instituted by a host of countries. In almost all cases the initial motivation was defensive in nature: the allocation of dwindling supplies of foreign exchange to ensure crucial international payments, the checking of capital flights, etc. As depression gave way to recovery, however, it became obvious that exchange control no longer tended to be regarded in the official circles of many countries as a measure of last resort to be shaken off at the first opportunity. Instead, it assumed greater importance as some countries found new uses for it. For example, during the course of the thirties exchange control in the hands of some countries evolved into a powerful instrument of economic nationalism.

With the outbreak of World War II in 1939, the existing exchange-control systems were strengthened, and many countries not already having systems of exchange control moved to adopt them. There was much to recommend the use of exchange control under wartime conditions. Particularly the active belligerents, unable to continue their usual volume of commercial exports, found that exchange control facilitated the selective

and discriminatory handling of the demands being made upon their diminished and dwindling supplies of foreign exchange. Exchange control had the merit of permitting the available supply of foreign exchange to be directed to the financing of those imports deemed most necessary for the prosecution of the war, and it permitted other demands to be either entirely eliminated or drastically curtailed.

The period of transition from war to peace after 1945 was marked by widespread distortions in production and trade which, it has been widely held, warranted the continuation of exchange control. As the postwar era wore on, however, there appeared to be some reason to believe that exchange control had come to be regarded, at least by some countries, not as a temporary device for coping with transitional problems, but rather as a necessary, and even desirable, system for dealing with long-run economic problems. It has frequently been asserted[1] that the continued popularity of exchange control far into the postwar years was not unrelated to the fact that when a country has such controls in effect it is able to force its international accounts into balance without its having to undergo other adjustments, either via exchange depreciation or domestic deflation.

The widespread use of exchange control is indicated in part by information contained in Table 18 in the preceding chapter. A summary of the exchange restrictions which a number of countries had in effect in 1954 upon imports of United States origin or upon goods payable in United States dollars is shown there.

THE PURPOSES OF EXCHANGE CONTROL

We have mentioned in a general way some of the reasons why exchange control was instituted and practiced. We may now examine these, and other, reasons in greater detail.

To Check Capital Flights

Exchange control may be used to prevent capital flights, and this purpose figured importantly in its introduction in Germany, Argentina, and some other countries during the early thirties. If adequately implemented and enforced, exchange control tends to be highly effective in curbing erratic outflows of capital; when exchange-control authorities refuse to sell foreign exchange for this purpose, they have closed the only legal avenue through which capital may leave a country.[2]

[1] See IMF, *Fourth Annual Report on Exchange Restrictions,* Washington, 1953, p. 7.
[2] Theoretically, capital may still leave in the sense, for example, that the proceeds

Aside from its use as a device to cope with capital flights, exchange control in recent years has been employed by numerous countries in their regulation of normal day-to-day capital movements. Exchange control in this form generally covers the exodus of domestic savings or the withdrawal of foreign-owned capital. Such controls vary widely in their degree of severity, ranging all the way from a mere formality to absolute prohibition.

The use of exchange control to control the outflow of capital is motivated largely by two major factors. First, erratic shifts of capital, especially in the case of fear-motivated capital flights, frequently serve to create or accentuate balance-of-payments difficulties. Rather than to bear the consequences, the countries concerned may choose to outlaw or closely control the outflow of capital, thereby preventing the potential difficulties from ever arising. Second, some countries, especially the capital-poor, underdeveloped countries, are prone to resist large-scale capital outflows, undertaken either by their own residents or by foreign investors. These countries tend to look upon exchange control as a means to retain capital at home, giving the owners no investment alternative other than domestic investment.

To Maintain Overvalued Currencies

Of the numerous purposes of exchange control, a fundamental one, which in almost all instances has figured importantly in the systems in existence after World War II, has been that of maintaining the international value of a country's currency at an overvalued level. Several other purposes, discussed in the following pages, derive from or are subsidiary to this fundamental purpose. How does exchange control help a country to maintain its currency at an overvalued figure? The answer is that exchange control, in allowing a country to ration relatively scarce supplies of foreign exchange among various demands, leaving some demands unfilled, permits the total demand to be confined to the level of the total available supply, even though the prevailing exchange rate is one which overvalues the domestic currency.

Why may a country seek to maintain an overvalued currency? The basic reason is that in choosing the method to be used in promoting balance in its balance of payments, a country may prefer the adjustment

of exports may be banked outside the country. This form of evasion, however, may be brought under control in various ways; for example, exchange control may be supplemented with a system of export licensing, the award of a license being made conditional upon the "pledge" to return the proceeds. Needless to say, since attempts at evasion may take many forms, complete control over capital movements requires the adoption of a comprehensive system of regulations, along with constant vigilance on the part of authorities responsible for enforcement.

process under exchange control to the other alternatives open to it. Specifically, if at the existing exchange rate the current demand for foreign exchange exceeds the pace at which the supply of foreign exchange is being replenished, balance may be restored in any one of three possible ways: (1) deflationary measures (monetary or fiscal) in the domestic economy may serve to decrease the demand for foreign exchange (as imports decline) and to increase the supply of foreign exchange (as exports increase) until at some point equilibrium is restored; (2) the rate of exchange may be allowed to depreciate in accordance with the dictates of a free market until at some new rate equilibrium is restored; or (3) the government may institute exchange control in order to limit the demand for foreign exchange to the supply becoming available, thereby allowing the maintenance of the existing exchange rate without resort to deflation. Neither of the alternatives to exchange control may prove attractive to a country. Deflation is ordinarily a bitter "pill" to swallow, and political pressures frequently serve to place its practice beyond the realm of practicality. Similarly, depreciation may be resisted for several reasons. As previously indicated, depreciation tends to (*a*) worsen a country's terms of trade, (*b*) foster inflation, and (*c*) increase the cost of debt service and repayment when the obligations are foreign-held and are payable in terms of a non-depreciated currency. In preference, a country may choose to maintain its currency at an overvalued figure, relying upon exchange control to force its international accounts into balance. While international accounts can be maintained in balance in this fashion, free-market equilibrium cannot be said to prevail.

To Safeguard Domestic Programs

Exchange control may be instituted by a country to allow it to pursue domestic policies of an anti-deflationary nature without its economy thereby becoming unduly vulnerable to adverse international repercussions. For example, if a single country chooses to embark upon a full-employment program in order to counteract a general deflation which also confronts other countries, certain consequences normally follow: the country's income and price levels tend eventually to rise relative to those abroad, leading to an increase in imports and to a decrease in exports. The reversal of trade flows tends to exert a dampening influence upon domestic expansion, and also tends to bring pressure to bear upon the country's international reserves. Thus, the efforts of one country to promote domestic expansion may be readily undercut if the forces of international adjustment are allowed to operate freely. If the country institutes exchange control in conjunction with its anti-deflationary program, how-

ever, it acquires the ability to control imports and such other transactions as give rise to a demand for foreign exchange. The importance of exchange control in this connection is that the curtailment of imports serves to eliminate a source of leakage in the domestic income stream, and also serves to prevent unwanted pressures from falling upon the country's international reserves.

In short, exchange control serves to insulate an economy, allowing it to pursue single-handedly an anti-deflationary program without its having to assume the risk that later its relatively prosperous domestic market may be "raided" through an influx of relatively cheap imports, or that its international reserves may later be subjected to intense pressure. It is because of this insulating effect that exchange control has long been a leading weapon in the economic arsenal of those countries which are committed to the idea of national planning.

To Control Trade

If a country finds that at the prevailing exchange rate it does not acquire sufficient foreign exchange to supply all possible demands, the line of attack through exchange control is to provide for the rationing of whatever supply is available. If foreign exchange is to be rationed, however, some standards must be established to cover allocation. Specifically: (1) What *uses* are to be eligible for foreign exchange? (2) What *firms* (or persons) are to be given access to foreign exchange? (3) In which *countries* are purchases to be made? In allocating foreign exchange among various uses, the usual procedure is to distinguish between demands as they relate to the transmission of money capital, to payment for merchandise imports, and to payment for various services. Movements of money capital are generally severely restricted or entirely ruled out, "essential" merchandise imports are generally accorded preferential treatment, and other demands are generally handled in a fashion lying somewhere between the two foregoing extremes, the precise situation depending basically upon the acuteness of the exchange scarcity. In allocating foreign exchange among various firms, carefully devised standards and conscientious administration are required if objectivity is to prevail. Otherwise, there is danger that particular importers may be favored over their competitors and that monopolies or quasi-monopolies may be created. In allocating foreign exchange among countries, exchange control provides a means for favoring imports from particular countries over imports originating elsewhere. Decisions as to the source of imports come to rest not only upon price and quality, but also upon the relative supplies of various categories of foreign exchange held in reserve or currently accruing.

In the process of allocating foreign exchange, trade comes to be controlled. This control affects the trade of both the importing country and countries abroad. First, in the importing country, the selective screening of imports under exchange control goes far in determining the lines of domestic production likely to prosper. For example, if one industry is eligible for foreign exchange, which allows it to import crucial supplies, while another industry is not equally eligible, the former tends to gain a relative advantage. Through exchange control some industries are in a sense given governmental assistance (though indirectly). Such assistance tends to promote the prosperity and growth of these industries, and serves, in turn, to direct domestic resources and manpower toward them. In short, exchange control may prove a factor in shaping the domestic economy. This is especially true when the domestic economy is heavily dependent upon imported materials.

Second, the exchange-control measures of one country may seriously affect foreign countries. For example, through use of exchange control a country may discriminate in its trade with other countries, i.e., imports payable in some currencies may be treated liberally while identical imports originating elsewhere may be treated less liberally or may be held entirely ineligible for foreign exchange. Such trade discrimination may be practiced in order to cultivate an economic link between countries or, conversely, to lessen a country's economic dependence upon particular foreign countries. As an illustration of the latter, Great Britain employed exchange control during the post-World War II years in order to shift some of her imports away from the dollar area, with which trade deficits existed, and toward the sterling-area countries and other non-dollar countries, with which no comparable deficits prevailed.

To Protect Domestic Industries

Exchange control enables a country to allocate foreign exchange on a product-by-product basis. It thus becomes possible to treat some types of imports less favorably than others. When imports are treated on a differentiated basis, the effect upon an import accorded relatively unfavorable treatment is similar to that which follows from the imposition of a tariff or a quota. The exclusion, or carefully controlled admission, of particular imports serves to protect the home market for competitive domestic producers.

Countries extending such protection to domestic producers generally do so for one of two reasons. First, discrimination against particular competitive imports may be held justified on grounds that infant industries, agricultural or industrial, need to be sheltered if they are to develop. There

is something to be said for the use of exchange control in this connection, provided the infant industries selected for protection are of the type which do not involve a misallocation of productive effort in the long run. Second, the reduction in import volume through use of exchange control is sometimes pictured as a way to increase the aggregate of domestic output and employment. The latter proposition, appealing though it may appear, is the outgrowth of an erroneous chain of thought. Advocates of the use of exchange control in this connection commonly fail to distinguish between the effect upon particular industries and upon the economy as a whole. The use of exchange control may readily yield greater output and employment in some industries, but such is not likely to be the case in an aggregate sense beyond relatively short-run periods. The essential point is that trade is reciprocal; when imports are curtailed, exports tend eventually also to decline.

On occasion, a multiple exchange rate system is employed in conjunction with exchange control in order to promote the growth of particular domestic industries. Discriminatory treatment then involves not merely a simple approval or denial of foreign exchange, but the procedure is further refined to allow two or more rates of exchange to apply in the purchase and sale of foreign exchange. Particular types of imports may be granted foreign exchange at more favorable rates than are accorded others; similarly, particular types of exports may be held eligible for more favorable selling rates than are accorded others. When two or more buying rates are maintained, those imports entering under the less favorable rate (or rates) are, in a sense, subject to an "indirect tariff"; when two or more selling rates exist, those exports eligible for the more favorable rate (or rates) are extended an "export subsidy." Multiple exchange rates are a common feature of the exchange-control systems of a number of underdeveloped countries which have long tried to promote economic development at home, e.g., Argentina and Chile.

In many countries, including those in which the adoption of exchange control was in the first instance entirely unrelated to the protection of domestic industries, the existence of such controls over an extended period of time serves to create vested interests which are prone to seek the continuation of the protection they come to derive from the presence of controls. The vested interests mentioned consist of (1) those new industries which tend to arise in consequence of the protection given by exchange control and (2) those long-established industries which come to recognize the advantage accruing to them in consequence of the protection given by exchange control. In either event, once exchange control has been in effect for some length of time, the resistance to its removal may

prove to be relatively great. There is reason to believe that this factor figured importantly in the decisions of various countries to continue exchange controls far into the post-World War II period.[3]

To Acquire Revenue

Finally, exchange control may be employed to acquire revenue for the government. Under a multiple exchange rate system, exchange-control authorities may establish both a purchase price, or prices, for foreign exchange and a separate selling price, or range of selling prices. The difference between the average buying rate and the average selling rate, less costs of operation, accrues to the government as profit. A number of countries (e.g., Argentina and Chile) employ exchange control for this purpose, among other purposes. Chile, for example, employs twelve buying rates, ranging from 19.37 to 248.00 pesos per dollar, and six selling rates, ranging from 31.10 to 248.00 pesos per dollar. It is especially significant that the export receipts of large mining companies (copper and iron), a leading source of foreign exchange for the country, are purchased at the minimum 19.37 rate; in contrast, sales occur at no figure lower than the 31.10 rate, and are heavily weighted at rates of 60.10 and 110.00.[4] In short, the government's profit on specific foreign exchange may far exceed 100 per cent. In defense of the Chilean practice, proponents generally argue that since the country's exports consist largely of irreplaceable minerals (incidentally, mined almost exclusively by foreign companies for foreign use), the government has a right to impose an indirect "export tax" upon their removal. Presumably the revenue derived by the government may be used to finance the development of the economy along other lines in anticipation of the day when the country's mineral resources come to be exhausted.

EXCHANGE CONTROL AND BILATERALISM

As we have previously observed, whenever a country has an overvalued currency, it suffers from a relative scarcity of foreign exchange. This situation compels the exchange-control authority to discriminate between various uses and firms in its allocation of available foreign exchange. If exchange control exists in many countries, as during the thirties and during the post-World War II years, it is almost inevitable that the exchange-control authority must, in addition, discriminate between countries in its

[3] See IMF, *Second Annual Report on Exchange Restrictions*, Washington, 1951, p. 12.
[4] IMF, *Fifth Annual Report on Exchange Restrictions*, Washington, 1954, pp. 78-83. Rates indicated are those in effect December 31, 1953.

allocation of foreign exchange. This is so because the scarcity of foreign exchange is not merely *general,* but tends to be relatively greater in the case of *particular* currencies than in the case of others. The fact that some currencies are relatively more scarce than others leads to *bilateralism,* i.e., to a deliberate balancing of accounts between pairs of trading countries. We may examine how this situation arises.

Under a free-market system, the connecting links between the cost and price structures and the income levels of various trading countries tend to promote a compatibility in exchange rates. Under exchange control, these connecting links are severed or weakened. Trade is no longer governed by international differences in cost and price to the extent characteristic under free-market conditions, and the forces which under free-market conditions serve to bring costs, prices, and incomes in different countries into equilibrium no longer operate freely. It is only natural, therefore, for some currencies to become undervalued compared to others, and hence to be in relatively greater demand and scarcer supply. A country practicing exchange control, when confronted by an exchange market of this nature, tends to be more liberal in its allocation of those currencies in relative abundance, while more stringent principles tend to be applied in the allocation of the relatively scarce currencies. The ease or difficulty in obtaining various currencies results in imports being shifted away from some countries and toward others. The general rule is that a country seeks to avoid a current-account surplus vis-à-vis those countries having "soft" currencies (i.e., those currencies which are relatively abundant, and which are not transferable to all third countries in payment of obligations), and seeks to avoid the conversion of foreign holdings of domestic currency into "hard" currencies (i.e., those currencies which are in relatively scarce supply).

Once currencies become generally inconvertible, multilateralism rapidly gives way to bilateralism. The essence of multilateralism is that surpluses earned with one country may be used to offset deficits incurred with other countries. When currencies are generally inconvertible, this possibility is ruled out. The alternative is bilateralism, which circumvents the need for convertibility by deliberately striving for a balancing of accounts as between pairs of trading countries. Such deliberate balancing of accounts has the potential disadvantage of leading to a lowered volume of trade. One way to forestall the latter development, however, is through resort to *bilateral agreements.* These are *agreements between pairs of trading countries designed to keep trade at a relatively high volume,* but to do so without the accumulation of uncleared balances (or "blocked balances"), which cannot be used to settle deficits payable in hard cur-

rencies, and without incurring deficits payable in hard currencies. The agreements seek to promote this overall objective by promoting trade on a basis which eliminates, or reduces, the need for settlement in gold or scarce foreign exchange. The agreements take three major forms: (1) private compensation agreements, (2) clearing agreements, and (3) payments agreements.

Private Compensation Agreements

This type of arrangement closely resembles barter. In its simplest form, a firm in Country A arranges to export a given volume of goods to a firm located in Country B, accepting in exchange a volume of imports of equivalent value. Imports thus compensate for exports, leaving no uncleared balance. This practice has the obvious disadvantage of compelling an exporter to act also as an importer. In order to get around this difficulty, special barter agencies frequently are created (sometimes sponsored by governments) to promote foreign outlets for goods, locate suitable imports, and arrange for the marketing of such imports among domestic firms. Financial settlement for both exports and imports may thus be effected domestically and in terms of domestic currency, the foreign-exchange market being entirely circumvented. In this manner, some transactions become possible which, considering the difficulties confronting trade when there is a general inconvertibility of currencies, are not otherwise possible.

Clearing Agreements

Clearing agreements differ from compensation agreements chiefly in that they provide a broader and more general procedure for offsetting claims. For example, under a clearing agreement between Countries A and B, importers in A pay for purchases from B by depositing the required amount in the currency of A to a clearing account maintained for B in the central bank of A. Exporters in A then are able to receive payment in domestic currency for goods shipped to B simply by drawing upon B's balances held in the clearing account. Similar arrangements may exist in B. If total payments and total receipts of each country vis-à-vis the other exactly balance over a given period of time, neither clearing account shows a deficit nor a surplus. In practice, however, an exact balance is not likely to occur. If A's claims upon B exceed B's claims upon A, for example, any one of several courses of action may follow: (1) the central bank of A may grant short-term credit to B on the assumption that balance is in prospect over a longer period of time; (2) A may ease its licensing of imports as applicable to purchases in B, while B may tighten its

licensing of imports as applicable to purchases in A, until accounts again balance; or (3) A may allow its claims to continue until the clearing agreement expires, at which time the unsettled balance may be carried forward under terms of a new agreement, or may be settled for through a payment by B of gold or acceptable currency.

The clearing procedure may cover not only payments arising from current merchandise trade, but also various other payments, including the transfer of interest, dividends, and principal, travel expenditures, payment for shipping services, remittances, etc. In each case exchange clearing provides a way to settle individual transactions between two countries in terms of domestic currency.

Payments Agreements

Payments agreements differ from clearing agreements chiefly in that they cover a wider range of transactions and use regular exchange instruments rather than special clearing accounts. In addition, very often a payments agreement is used to link an exchange-control country with a free-exchange country, whereas clearing agreements exist when both countries have exchange control.

Payments agreements have two principal uses. First, they are used to assist in the liquidation of some forms of debt. For example, a creditor country may conclude a payments agreement with a debtor, exchange-control country, under terms of which the debtor agrees that a specified portion of its current earnings is to be earmarked for the servicing or liquidation of past obligations, while the remainder of current earnings continues to be free for use in financing current purchases from the creditor. Second, payments agreements may be used to expand trade. For example, if A discovers that its exports to B are exceeded by its imports from B, bilateral balancing may be achieved either through a contraction of imports by A or through an expansion of imports by B. Given such alternatives, B may agree to a payments agreement with A, under terms of which B exercises control over the allocation of foreign exchange so as to allow additional imports from A, hoping thereby to equate total imports with total exports as far as trade with A is concerned.

IS THERE A CASE FOR EXCHANGE CONTROL?

During the past two decades there has been much discussion among economists and laymen as to the justification, or lack of it, of exchange control. A very usual "American attitude" has been that exchange control constitutes an impediment to trade, and that countries should therefore

remove such controls at the earliest opportunity. In contrast, in some countries (e.g., Great Britain) a very usual attitude has been that exchange control is capable of rendering a valuable service, and that caution should therefore be exercised in the removal of such controls. In view of the long-standing nature of the controversy, and the millions of words which have been written and spoken on the subject, the question may be raised directly at this point: Is there a case for exchange control?

Those who are critical of exchange control have one outstanding argument: exchange control serves to restrict the scope of international specialization and for this reason leads to a generally poorer utilization of the world's productive effort. These critics in reality hold that the allocation of productive effort which occurs in response to the forces of a free market is economically preferable to any allocation which may arise under the arbitrary rules and regulations established by government.

In contrast, the outstanding merit attributed to exchange control by its supporters is that it allows a country to insulate itself from external disturbances which, under free-market conditions, on occasion force drastic domestic adjustments (either price or income deflation or exchange depreciation). Advocates of exchange control who argue along this line in reality hold that the unimpeded operation of the free-market system does not necessarily produce the best possible results. They are inclined to argue that a government can do much to tone down the magnitude of the problems inherent in an adjustment process, if not indeed to prevent the need for an adjustment altogether. A second basic merit attributed to exchange control is found in the control it gives over erratic and disequilibrating capital movements.

The basic point of controversy between the critics and the supporters of exchange control thus centers upon the question of whether or not a free-market economy is preferable to a planned economy. Whatever the answer to this fundamental question may be, there is one point upon which most persons, be they critics or supporters, are able to reach a high degree of agreement. This point concerns the proposition that exchange control can render a service in promoting exchange stability during a time period (presumably a relatively short period) in which *remedial measures* are undertaken to counteract disequilibrium in a country's balance of payments.

The situation during the immediate post-World War II period perhaps best illustrates this service of exchange control. Countries which had been profoundly affected by the war were hardly in a position to resume "normal" trading relationships in short order. Export capacity was generally low, import demands were high, relative cost and price structures were

badly distorted, etc., all of which meant that if the conditions of a free market were adhered to, resultant adjustments were likely to be sudden and large-scale, perhaps entailing disastrous economic and political consequences. There seemed little reason, however, to allow the prevailing balance-of-payments difficulties to force the countries to undergo either domestic deflation or exchange depreciation, especially since it appeared likely that basic circumstances were sure to be altered once recovery got under way. Rather, there appeared to be a good case for exchange control, since the latter offered a way to protect existing exchange rates, and to lessen balance-of-payments deficits, during a difficult transition period.

Few persons were inclined to doubt the essential economic merit of exchange control as a temporary device for dealing with the problem at hand. As the postwar period wore on, however, exchange control continued. Most countries gave little evidence of being about to terminate controls; in fact, there appeared to be considerable evidence that some countries had come to view exchange control as an instrument, not for regulating temporary or special situations, but for regulating all or most foreign transactions on a continuing basis. In assessing the reasons for the continued widespread use of exchange control, the International Monetary Fund had the following to say in its 1952 report:

> In their efforts to satisfy the competing claims of divergent social and economic objectives, many countries have adopted economic and monetary policies which have meant that they were attempting to live beyond their means. . . . Measures which it is feared will be unpopular are either not taken at all or taken only after long delay and then not pushed far enough.[5]

Thus, even if the use of exchange control can be condoned in general, can it be condoned if employed by a country to delay or prevent long-run adjustments in the domestic economy, as distinct from its use as a device to assist the country in coping with a temporary difficulty in its balance of payments? It appears fair to conclude that the most common criticism is directed not so much at exchange control *per se* as at the "permanent" status it so readily acquires.

SUMMARY

Exchange control provides a system for the mobilization of foreign exchange and its subsequent allocation on terms determined by a central governmental authority. Little used prior to the Great Depression, ex-

[5] IMF, *Third Annual Report on Exchange Restrictions,* Washington, 1952, pp. 4-5.

change control has since (especially during the years immediately following World War II) evolved into a leading form of foreign-trade control.

When exchange control is widely used, bilateralism tends to follow. The prevalence of inconvertible currencies under exchange control hampers multilateralism; bilateralism arises as a way around the trading difficulties which exist when currencies are no longer convertible.

The outstanding advantage of exchange control is that it allows a country to insulate itself from external disturbances. The outstanding disadvantage of exchange control is that it restricts the scope of international specialization and thus entails a generally poorer utilization of the world's productive effort.

SELECTED REFERENCES

Ellis, H. S., *Bilateralism and the Future of International Trade,* Essays in International Finance, No. 5. Princeton: Princeton University Press, 1945.

°————, *Exchange Control in Central Europe.* Cambridge: Harvard University Press, 1941.

————, "Exchange Control and Discrimination," *American Economic Review,* December, 1947.

Gordon, M. S., *Barriers to World Trade.* New York: The Macmillan Company, 1941, Part II.

Harris, S. E., *Exchange Depreciation.* Cambridge: Harvard University Press, 1936, Chaps. I-II.

International Monetary Fund, *Fifth Annual Report on Exchange Restrictions,* Washington, 1954. (See other annual issues also.)

°League of Nations, *International Currency Experience,* Geneva, 1944.

°Mikesell, R. F., *Foreign Exchange in the Postwar World.* New York: The Twentieth Century Fund, 1954, Part II.

Robinson, J., "Beggar-My-Neighbor Remedies for Unemployment," in *Essays in the Theory of Employment.* Oxford: Blackwell, Ltd., 1947. Reprinted in American Economic Association (ed.), *Readings in the Theory of International Trade.* Philadelphia: The Blakiston Company, 1949.

Triffin, R., "Exchange Control and Equilibrium," in S. E. Harris (ed.), *Foreign Economic Policy for the United States.* Cambridge: Harvard University Press, 1948.

10

Exchange Control: II

THE BASIC PRINCIPLES concerning exchange control may be illustrated by reference to the experience of particular countries. This chapter treats two cases: Great Britain and Argentina.

GREAT BRITAIN

Two major factors warrant that special attention be directed to the system of exchange control in effect in Great Britain during roughly the past two decades. First, the currency in question, the pound sterling, occupies a "key" position in international trade and finance. In addition to being the currency of Great Britain, sterling serves as the anchor currency for the currencies of a number of other countries. Great Britain and the countries linked to her currency-wise together comprise what is known as the "*sterling area.*" In these countries live about one-third of the world's people. Second, the volume of trade and finance conducted in terms of sterling is relatively great, approximating one-half of the world's total. Clearly, when a system of exchange control involves a currency of the stature of sterling, some knowledge of that system is essential to an understanding of what is going on in the international economy. The ensuing pages, therefore, summarize reasons for the origin and continuation of exchange control, as well as the mechanics of the system. First, however,

it may prove helpful, as background information, to examine the origin and nature of the so-called "sterling area."

Development of the Sterling Area

The focal point of the sterling area is Great Britain, and other members today include Australia, Burma, Ceylon, Eire, Iceland, India, Iraq, Jordan, Libya, New Zealand, Pakistan, Southern Rhodesia, the Union of South Africa, and all British Colonies, Protectorates, Protected States, and Trust Territories. Membership is not constant; on occasion some countries have entered and others have withdrawn. A country is considered a member when it meets two tests: (1) it maintains its currency at a fixed exchange rate with the pound sterling, and (2) it maintains all or most of its exchange and monetary reserves in terms of sterling in London. A fundamental attribute of the sterling area is that exchange proceeds earned in any part of the area may be freely transferred and used in any other part of the area.

The sterling area came into being in 1931 when Great Britain abandoned the international gold standard. The latter action resulted, basically, from an unwillingness on the part of Great Britain to continue to formulate her domestic monetary policies (and other economic policies) within the relatively rigid frame of reference posed by the conditions of an international system. In abandoning the gold standard, Great Britain in a sense served notice that henceforth she would pursue independent domestic planning, whenever such action was considered advantageous. Once the international gold standard had been abandoned, the sterling area came into existence as each of a number of countries sought to replace the fixed tie between its currency and gold with a fixed tie between its currency and the British pound sterling.

A number of factors, both non-economic and economic in character, serve to explain why some countries sought to tie their currencies to the pound sterling (i.e., to "peg" their exchange rates to the sterling rate). One possible motivating factor, non-economic in character, involved the sentimental tie which exists between Great Britain and the other members of the British Commonwealth of nations. Sentimentality, although important, definitely was not the major factor, however, since a number of countries not members of the British Commonwealth have been (and are) in the sterling area, and one of the more important British dominions, Canada, has never been in the sterling area. (Canada's economic ties are much stronger with the United States than with Great Britain.) Fundamentally, three economic factors accounted for the willingness, and desire, of some countries to enter the sterling area. First, sterling was an important cur-

rency in the world; it was widely used, and its prestige was relatively high. As gold ceased to be an "international standard of value," particular countries sought to tie their currencies to another "standard of value," the pound sterling in this case. Second, Great Britain constituted the major market for the exports (specifically, raw-material exports in almost all instances) of a number of countries. These countries sought to promote a close currency link between Great Britain and themselves in the hope that such might facilitate their commercial relationships. In tying their currencies to sterling (so that their currencies and sterling would fluctuate together), the exporting countries were able to protect the commodity prices and the competitive position of those producers dependent upon the British market. Third, a number of countries were debtors of Great Britain, and they accordingly desired a fixed exchange rate between their currencies and the pound sterling in order to preserve a constancy of cost in servicing their obligations.

In linking their currencies to the pound sterling, the member countries of the sterling area were assured of stable exchange relationships in their dealings with Great Britain, and with one another. The countries had no similar assurance, however, of exchange stability in their dealings with the non-sterling-area sector of the trading world. For example, any shift in the value of the pound sterling vis-à-vis any non-sterling-area currency (e.g., the dollar) served to alter (i.e., worsen or improve) the trading relationships between the sterling-area countries and any particular non-sterling-area country, just as had been the case prior to the inauguration of the sterling area. The fact, however, that the sterling area came to include numerous countries meant that a considerable portion of the world's trade and finance was carried on under stable exchange conditions. This situation tended to encourage trade within the area. The basic gain for Great Britain was that she continued to be at the center of a wide trading area, much as had been the case under the international gold standard. In short, the sterling area was a *currency* system, but it was motivated largely by *commercial* factors, both as viewed by the various members other than Great Britain and by Great Britain herself.

Introduction of Exchange Control

At the outset of World War II Great Britain, and the other countries of the sterling area,[1] introduced exchange control. This action was taken in order to minimize, if not to avert entirely, the pressures likely to be exerted upon the balances of payments of Great Britain and the Com-

[1] Some members dropped out at this point, e.g., Portugal, the Scandinavian countries, Egypt, and Thailand.

monwealth countries under wartime conditions. It was felt that a reduced volume of exports to non-sterling-area countries, coupled with high import demand in the sterling-area countries, especially in Great Britain, made imperative the mobilization of the relatively scarce supplies of foreign exchange and their subsequent allocation in order to promote the achievement of desired ends. Essentially, exchange control was visualized as a device by means of which Great Britain, situated at the core of the sterling area, might conserve her relatively scarce supplies of *gold and dollars,* or at least might obtain maximum advantage from the use of those which she did possess or did come to acquire.

The basic features which characterized the sterling area during prewar years remained in force throughout the war period. Currencies of member countries continued to exchange at a fixed rate with sterling, and their official monetary reserves continued to be held (entirely or in part) in terms of sterling in London. In addition, however, two new features were introduced. First, all member countries of the sterling area adopted systems of exchange control similar to the system in effect in Great Britain. From this point on the sterling area was more than a multi-country currency system; henceforth there was also a high degree of uniformity in the import policies (or, generalized further, the exchange policies) of the various member countries. Second, all member countries agreed to *pool* their resources of non-sterling-area exchange and gold in London. For example, if India, a sterling-area country, earned dollars in excess of her needs under the existing exchange-control regulations, these "surplus" dollars were subject to transfer to London in exchange for sterling. India gave up dollars and acquired sterling;[2] Great Britain acquired more dollars than those earned by her alone, but in acquiring the additional dollars she increased her sterling liabilities to India. Great Britain was by this means placed in the position of being able to finance a greater volume of imports from dollar-area and other non-sterling-area countries than otherwise possible, a situation made possible by the willingness of the other sterling-area countries to forego (or perhaps only postpone) the use of some of their receipts of non-sterling-area exchange, as well as gold reserves, on their own accounts.

The gain to Great Britain from a pooling of exchange and gold resources was clear-cut, but the other sterling-area countries presumably also foresaw benefits or they would have rejected the innovation. Briefly, the possible benefits to the latter were three-fold: (1) the winning of the

[2] In the example, India would also acquire sterling through her own sales to Great Britain (including receipts acquired through British military outlays in India, estimated to have been in excess of £1 billion during World War II).

war was regarded a common objective, so that the transfer of exchange and gold resources to London was in a sense a contribution to the common war effort, much like the recruitment of military personnel for use in a joint campaign; (2) the economic health of Great Britain was regarded as essential to the economic well-being of the individual sterling-area countries (since the foreign markets of the latter lay largely in Great Britain), so that the transfer of exchange and gold resources was tantamount to an "investment" of the countries in themselves; and (3) the exchange and gold pooled in London was in a sense merely being held in trust for the individual sterling-area countries since the latter were given the right to repurchase from the pool whenever such resources were needed to finance those transactions allowable under prescribed exchange-control regulations.

Significantly, the net effect of the generalization of exchange controls throughout the sterling area and the pooling of dollar and other non-sterling-area exchange resources in London was to create a wide area within which transactions (trade or finance) were relatively free of controls, but to raise special barriers against similar transactions with countries outside the sterling area. In short, *multilateralism* continued to prevail within the sterling area, but currency *discrimination* marked commercial relationships with countries outside the sterling area.

The system of exchange control developed by the sterling-area countries during World War II was continued in substantially unchanged form after the war. The reason was that during the postwar years the sterling area continued to experience payments difficulties in its dealings with other parts of the trading world, especially with the dollar area. Throughout the postwar period, the sterling area was confronted with a persistent "dollar shortage," i.e., a shortage of dollar exchange relative to the demand for it at the existing rates of exchange. While the magnitude of the "shortage" varied from year to year, reaching a peak in 1947 and totaling lesser amounts in other years, the sterling area was never entirely free of the problem. The dollar shortage was traceable in part to the balance-of-payments deficits incurred by Great Britain, and in part to deficits incurred by various other sterling-area countries; in view of the nature of the sterling area, however, the resultant problem was one which fell upon the entire sterling area.

In an attempt to cope with the dollar-shortage problem, several major steps were taken, three of which bear mention here. First, during the postwar years the United States extended substantial loans and grants to Great Britain in an attempt to bridge the "dollar gap." Second, in late

1949 Great Britain depreciated the pound sterling from $4.03, the official rate during and after the war, to $2.80 in an attempt to eliminate, or diminish, her balance-of-payments deficits with the dollar area. The British action was paralleled by similar actions in other parts of the sterling area. Third, exchange rationing, as indicated earlier, remained in effect throughout the period. The direct effect of the exchange rationing was (1) to curb the demand for dollars by restricting the right of importers to buy goods and services (or to engage in investment transactions) requiring dollars, and thus (2) to shift trade from the dollar area to an intra-sterling-area basis or to those non-sterling-area countries outside the dollar area.

Operation of Exchange Control

Exchange control was introduced in Great Britain in 1939. During succeeding years, many changes in detail occurred, but the essentials remained fundamentally unchanged. Current provisions (1954) have their legal origin in the Exchange Control Act of 1947. Major elements of the system are summarized below:[3]

1. **Coverage.** The restrictions in effect do not apply to transactions with other countries in the sterling area; rather, they apply only to transactions with non-sterling-area countries.

2. **Exchange Rate.** The system is a single-rate system, all authorized foreign transactions occurring at, or near, par value: £1=$2.80 (in effect since September, 1949). The market rates for most currencies are maintained between official limits corresponding to U. S. $2.82 buying, and U. S. $2.78 selling, per £1.

3. **Administration.** Exchange control is administered by the Bank of England, acting on behalf of the Treasury. Much of the normal day-to-day business is handled by commercial banks, almost all of whom are authorized to engage in this business.

4. **Licensing.** Imports on private account, when subject to exchange control, require import licenses; imports on government account require no licenses. Export licensing also exists but, as in some other countries, is not related to exchange control. All licensing is handled by the Board of Trade.

[3] As of January 1, 1954, unless otherwise specified. The factual information is drawn largely from IMF, *Fifth Annual Report on Exchange Restrictions*, Washington, 1954, pp. 307-313.

5. Exchange Receipts. All exchange receipts in specified currencies,[4] whether received in payment of merchandise exports or the sale of invisibles, or as transfers of capital, must be surrendered (sold) to an authorized bank. In simple terms, residents acquiring currencies of certain non-sterling-area countries (e.g., United States dollars, Canadian dollars, etc.) are legally required to sell them to an authorized bank at the going rate.

6. Exchange Payments. An outstanding, and crucial, feature of the British exchange-control system is the manner in which withdrawals may be effected. All transfers through banks are classified under certain major headings, and are handled by the banks in accordance with existing exchange regulations. The major headings are as follows: (1) *Resident Accounts,* the sterling accounts held in British banks by residents of the sterling area, and (2) *Nonresident Accounts,* the sterling accounts (other than blocked accounts) of nonresidents, i.e., those resident outside the sterling area. The Nonresident Accounts, in turn, are of three basic types (effective March 22, 1954, following a simplification of the sterling-account arrangements): (a) *American Accounts,* accounts held by residents of the United States, of the Philippine Republic, and of a number of Latin-American countries,[5] and *Canadian Accounts,* accounts held by residents of Canada, (b) *Transferable Accounts,* accounts held by residents of some forty-five countries, territories, or monetary areas,[6] and (c) *Bilateral Accounts,* accounts held by residents of three countries.[7]

Separate exchange treatment is accorded funds included within each category of accounts. *Resident Accounts* are freely transferable within Great Britain or between it and other parts of the sterling area. In contrast, transfers to *Nonresident Accounts* may occur only upon approval. Transfers to *American Accounts* (and to *Canadian Accounts*) typically are

[4] These specified currencies are listed as follows: Belgian francs, Canadian dollars, Congolese francs, Deutsche marks, francs of the French Franc Area, French Somali Coast (Djibouti) francs, Indo-Chinese piastres, Luxembourg francs, Netherlands, Surinam, and Netherlands Antilles guilders, Panamanian dollars, Philippine pesos, Pondicherry rupees, Portuguese escudos, Swiss francs, and U. S. dollars. (Danish and Faroese kroner, Norwegian kroner, and Swedish kronor were added to this list on March 22, 1954.)

[5] In detail, Bolivia, Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Liberia, Mexico, Nicaragua, Panama, Philippine Republic, United States and possessions, and Venezuela.

[6] Afghanistan, Albania, Andorra, Anglo-Egyptian Sudan, Argentina, Austria, Belgian Monetary Area, Brazil, Bulgaria, Chile, Mainland China, Czechoslovakia, Denmark, Egypt, Ethiopia, Finland, Fed. Rep. of Germany, French Franc Area, French Somaliland, Greece, Israel, Italian Monetary Area, Japan, Lebanon, Nepal, Netherlands Monetary Area, Norway, Paraguay, Peru, Poland, Portuguese Monetary Area, Rumania, Saudi Arabia, Spanish Monetary Area, Sweden, Switzerland, Syria, Taiwan, Tangier, Thailand, Uruguay, U.S.S.R., Vatican City, Yemen, and Yugoslavia.

[7] Hungary, Iran, and Turkey.

closely screened in view of the dollar shortage (i.e., the transfers give rise to claims payable in dollars, and are therefore closely controlled). Payments from these accounts, however, may be freely made to any account related to countries in this category or to countries in any other category.

Transferable Accounts are freely transferable between any of the countries in this category, and transfers from Resident Accounts, American Accounts, or Canadian Accounts to them (but not from such accounts) may occur without official approval. Status in this category is obtained by a country when it reaches an agreement with Great Britain to accept currently earned sterling in any amount from any source. The possible advantage to the individual country is that through the acceptance of sterling it may be able to widen its trade area.

Bilateral Accounts for the most part cover those countries outside the sterling area that do not wish to assume the status of Transferable Account countries. Their unwillingness may stem from the fact they already hold sterling balances in excess of their needs for that currency, and they may therefore feel disinclined to throw themselves open to an unregulated acceptance of the currency. Great Britain may in these cases arrange for bilateral status, leading to an approximate balancing of accounts at a given volume of trade. This category at one time included over twenty countries but, following a simplification of the sterling-account arrangements, the number of countries was reduced to only three. Other countries once in this category shifted their status to that of Transferable Account countries.

It is important to note that the prescribed arrangements are not inflexible; in fact, considerable ("administrative") transferability is achieved by granting licenses to effect payments outside the prescribed arrangements.

Summarizing the above arrangements, the sterling accounts, for all practical purposes, may be said to be of three types: (1) Resident Accounts, held by residents of the *sterling-area* countries, (2) Nonresident Accounts held by residents of the *dollar-area* countries (American Accounts and Canadian Accounts), and (3) Nonresident Accounts held by residents of *other*, non-dollar-area, non-sterling-area countries (Transferable Accounts and Bilateral Accounts).

7. **Merchandise Imports.** Payment for imports arising in other parts of the sterling area may be freely made in sterling or in any other sterling-area currency. Payment for imports from outside the sterling area, however, is subject to approval by means of the import-licensing system handled by the Board of Trade. The specific treatment given depends fundamentally upon the classification accorded a particular country in the basic scheduling of nonresident accounts.

8. Invisibles. In making payment for invisible-trade items, an exchange license is required if the scheduled payment is to a country outside the sterling area. Such licenses are normally granted without discrimination between recipient countries when payments are made pursuant to contracts entered into prior to the enactment of exchange control in 1939, or are made pursuant to contracts entered into with approval after that date (exclusive of movie film rentals, which are covered by special agreement). Applications for licenses for noncontractual payments are considered individually on their merits, and are sometimes subject to certain monetary limitations, and in a few instances are subject also to discrimination between countries.

British tourists visiting certain countries are limited to £50 per adult per 12 months, exclusive of the payment of fares, which sum is not limited on direct journeys to and from Great Britain, provided the fare is paid within Great Britain. There is also a limit of £5 per person upon the amount in British banknotes which may be taken out of the country. The latter provision is designed to prevent any large-scale sale of British pound sterling at depreciated rates in some foreign "black market."

9. Capital Transfers. All transfers of capital to countries outside the sterling area require approval. An exception exists in the modification which provided that investments undertaken by nonresidents after January 1, 1950, may be repatriated at any time, together with capital profits, provided the project initially had the approval of exchange-control authorities.

10. Overall Objective. The major objective of the foregoing regulations has been the conservation of relatively scarce dollars and gold. The achievement of this objective has been promoted in large part by a deliberate attempt to shift trade from the dollar area (the hard-currency countries) to the sterling area or to those non-sterling-area countries among whom sterling is generally transferable (the soft-currency countries).

ARGENTINA

Exchange control was instituted in Argentina in 1931, largely in response to two developments. First, the country's raw-material exports suffered pronounced price declines under the prevailing depression conditions, causing a serious dwindling of exchange reserves. Second, monetary difficulties in Great Britain, to whom Argentina had long been closely linked economically, resulted in exchange-rate instability between sterling and the peso. The resort to exchange control accordingly reflected an

attempt to mobilize and stabilize the exchange resources accruing to the country.

Although there have been many modifications over the years, the basic features of the Argentine exchange-control system have been in effect since its inception. The major features of the system which serve to direct attention to it are (1) the coexistence of a controlled exchange market and a free exchange market, and (2) the formal use of a multiple exchange rate system.

Coexistence of Controlled and Free Markets

In most countries, the exchange-control authority is the exclusive buyer and seller of foreign exchange, and such "black-market" transactions as occur outside the controlled framework are illegal and punishable. In Argentina, the "black market" is, in a sense, given legal sanction in that a free exchange market is permitted to flourish alongside a controlled exchange market. While the free exchange market is generally relatively small, its transactions never exceeding one-fifth of total transactions, its presence nevertheless serves to remove some of the harshness frequently attributed to exchange control. Exchange derived from specific sources (e.g., tourist receipts, ocean freights, and imports of capital) is allotted to the free market, and such supplies are available for purchase by persons not eligible for exchange in the lower-priced, controlled exchange market. The great bulk of Argentina's exchange transactions, however, occur through the controlled exchange market. All of the major exports are handled through it, as are most imports.

Multiple Exchange Rates

The second outstanding feature of the Argentine exchange-control system is its use of multiple rates of exchange. There are a total of nine buying rates and three selling rates. The situation may be summarized as follows (rates indicate pesos per U.S. dollar)[8]:

	Buying		*Selling*
5.00	Basic exports (grains, beef, etc.) and wool and raw sheepskin exports paid for in currencies other than U. S. dollars or sterling.	5.00	Preferred imports (coal, coke, fuel oil, and crude petroleum).

[8] As of January 1, 1954. The factual information is drawn largely from IMF, *Fifth Annual Report on Exchange Restrictions,* Washington, 1954, pp. 335-339.

6.25	(50% at 5.00 rate and 50% at 7.50 rate.) Wool and raw sheepskin exports paid for in U. S. dollars or sterling.		
7.50	Minor exports (largely processed meats, manufactures, and semi-manufactures).	7.50	Essential imports.
10.08	(60% at 7.50 rate and 40% at "Free" Market Rate.) Minor exports (butter, casein, quebracho, etc.).		
10.37	(40% at 5.00 rate and 60% at "Free" Market Rate.) Minor exports (salted horse meat).		
11.37	(40% at 7.50 rate and 60% at "Free" Market Rate.) Minor exports (cheese).		
12.015	(30% at 7.50 rate and 70% at "Free" Market Rate.) Minor exports (tanned cattle hides).		
12.16	(20% at 5.00 rate and 80% at "Free" Market Rate). Minor exports (frozen horse meat).		
13.95	(Controlled "Free" Market Rate.) Marginal exports; invisibles; capital.	13.95	(Controlled "Free" Market Rate.) Nonessentials and luxury imports; invisibles; capital.

Receipts of foreign exchange may be converted into pesos at any one of nine possible rates. Most receipts, however, are converted at only one of three of these rates. For example, receipts for most of the country's leading export products (e.g., beef, wheat, and corn) are converted at the "basic export rate" of 5.00 pesos per dollar, while receipts for other products (generally those more difficult to market, including manufactures and semi-manufactures) are converted at the "preferential export rate" of 7.50 pesos per dollar. The government thus, in effect, extends an "export subsidy" of 50 per cent to one form of economic endeavor as compared to another. Under the circumstances, exporters find it to their advantage

to explore every avenue in an attempt to get their products classified as eligible for the "preferential" rate rather than the "basic" rate. In addition to these two rates, a limited volume of exportation is eligible for exchange conversion at the "free" rate, a rate fixed ("controlled") at 13.95 pesos per dollar (but labeled "free" because free exchange market transactions occur at that rate).

For an extended period (August, 1950, to February, 1952), the three rates cited were the only buying rates in effect. Beginning in 1952, however, a gradual shifting of export transactions to more advantageous rates for exporters was begun, resulting in the adoption of six "mixing" rates at 6.25, 10.08, 10.37, 11.37, 12.015 and 12.16 pesos, respectively, per dollar.[9] The objective in adding these rates was to stimulate exports; for example, the 6.25 buying rate was intended to encourage wool sales in dollar and sterling markets.

The various forms of import transactions, too, are handled on a differentiated basis. Relatively favorable treatment is extended imports of those commodities (e.g., coal, coke, fuel oil, and petroleum) in which the country is deficient but which it sorely needs if its dream of industrialization is to materialize. These imports are eligible for foreign exchange under the "preferential import rate" of 5.00 pesos per dollar. The bulk of imports, however, are eligible for exchange only at the "basic import rate" of 7.50 pesos per dollar, and payment for "nonessentials" is undertaken at the prevailing "free" rate. Argentine residents desiring funds to finance foreign travel, for example, are obliged to purchase foreign currencies at the "free" rate.

The multiple exchange rate system has been motivated by two major factors. First, the system enables Argentina to discriminate in favor of or against particular commodities or exchange uses. Beef, wheat, and corn, the country's leading export products, hold a comparative advantage in world trade, and hence it is generally felt they require no special exchange treatment. In contrast, commodities which do not have a clear-cut international advantage, or which derive from those domestic industries actively encouraged by the government, are granted an "export subsidy" through preferential exchange treatment. As for imports, the desire to promote industrialization provides the rationale for preferential exchange treatment for those commodities needed by industry but not obtainable at home, e.g., coal, coke, etc. Other imports are given no such encouragement and, in fact, so-called "nonessentials" are deliberately discouraged

[9] The latter are known as "mixing" rates since they reflect the composite of two other rates. For example, the 10.08 rate represents conversions where exchange receipts are converted 60% at the 7.50 rate and 40% at the "Free" Market Rate.

through the application of relatively unfavorable exchange rates.

Second, the multiple exchange rate system provides revenue for the government. Since the bulk of foreign exchange is purchased at 5.00 pesos per dollar and is sold at 7.50 pesos per dollar, the government realizes a profit. This profit may be considerable if the country is a leading trading country, as Argentina is. Actually, much of the profit realized by domestic producers or traders under other circumstances accrues to the government under the prevailing procedure. In Argentina, the profits so derived have been used in part to service or purchase foreign investments held within the country, and in part to finance new domestic projects without having to rely upon borrowed funds, either foreign or domestic.

SUMMARY

Exchange control was instituted in Great Britain, and in other countries of the sterling area, at the outset of World War II. The action was taken in order to mobilize and conserve relatively scarce supplies of foreign exchange (non-sterling-area exchange) and gold under wartime conditions. During the war, export capacity was relatively low and import needs were relatively high; under the circumstances, exchange control served as a device for rationing relatively scarce exchange resources among those uses deemed of greatest benefit to the country. Exchange control was continued after the war in order to limit the magnitude of the so-called "dollar shortage." Essentially, exchange control was used to divert some portion of imports from the dollar area to the sterling area or to other non-dollar-area countries.

Exchange control was instituted in Argentina in 1931. The system in effect is characterized by two outstanding features: (1) the coexistence of a controlled exchange market and a free exchange market, and (2) the use of multiple rates of exchange (e.g., nine buying rates and three selling rates in 1954).

SELECTED REFERENCES

°Conan, A. R., *The Sterling Area.* London: Macmillan & Co., Ltd., 1952.

Crosland, C. A. R., *Britain's Economic Problem.* London: Jonathan Cape, Ltd., 1953.

Crump, N., *The ABC of the Foreign Exchanges,* 11th ed. London: Macmillan & Co., Ltd., 1951, Chap. XXVII.

Day, A. C. L., *The Future of Sterling.* Oxford: Clarendon Press, 1954.

°International Monetary Fund, *Fifth Annual Report on Exchange Restrictions,* Washington, 1954. (See other annual issues also.)

11

State Trading

DURING RECENT YEARS, a substantial portion of world trade has been handled directly by governments (as distinct from private traders), such trade usually occurring through special state-trading agencies operated or controlled by individual governments. This chapter summarizes major factors responsible for the growth of state trading, and evaluates some effects which stem from its practice. Included also is a brief description of the state-trading operations of the U.S.S.R., Great Britain, and Argentina. Those foreign-trade operations of the United States which, according to some tests, may be classed as state-trading operations are also cited.

THE DEVELOPMENT OF STATE TRADING

A country is said to practice state trading when its government undertakes to carry on foreign trade on its own accord, either to the exclusion of private traders or alongside private traders. Virtually nonexistent several decades ago, state trading is of considerable importance today, although probably of somewhat lesser importance than during the early years following World War II.

Two major factors may be cited in the development of state trading:

First, the growth of state trading has closely paralleled the spread of

socialism, an important aspect of which has been the integration of foreign trade within the framework of domestic economic planning. The U.S.S.R., for example, is deeply committed to the principle of national economic planning and, accordingly, all foreign trade, both exportation and importation, is handled through a system of state trading. A similar situation prevails in the "satellite" countries fringing the Soviet Union. In those countries which adhere to socialism in a milder form, state trading and private trading generally tend to coexist. In Great Britain, during the years of the Labor Government's power following World War II, state trading and private trading were coexistent. Significantly, the end of the Labor Government, and the return of the Conservatives to power, also witnessed the decline of state trading. Similarly, in Argentina, the attempt through state planning to accelerate the rate of economic development was responsible, at least in part, for the introduction of state trading. In Argentina, as was the case in Great Britain, state trading and private trading coexist.

Second, the growth of state trading has been aided during the post-World War II years by the relative shortages of foreign exchange experienced by particular countries. For example, the state-trading operations undertaken by Great Britain in large part reflected an attempt to conserve relatively scarce dollars by means of a state-directed shift of imports to non-dollar countries.

While additional economic factors have figured in the growth of state trading, the two cited are of greatest single importance. In addition to its economic motivations, however, state trading may also have a political motivation.[1] When the government of a country, especially if it is a large and powerful country, has wide discretionary power to determine the volume, direction, and timing of both imports and exports, it is in a strong position to use its foreign trade as a political weapon in the game of international politics. This situation is discussed below in some detail in the case study of the U.S.S.R.

THE SOVIET FOREIGN-TRADE MONOPOLY

The foreign-trade monopoly of the government of the Soviet Union is merely one facet of that government's domination of national economic life. Though it concerns only one aspect of economic life, state trading is

[1] In a historical sense, use of state trading as a political device probably developed as a by-product once such operations had been instituted for other (economic) reasons. Viewed from the standpoint of the present, however, state trading may be used to promote political ends.

nevertheless an integral part of the total scheme of things. For this reason, its origin and operation may perhaps be most readily comprehended if treated within the context of the overall economy.

Soviet Economic Planning

Following the overthrow of the Czarist government in 1917, the new regime which assumed power in Russia was confronted with the tremendous task of coping with the problems of an impoverished economy only little removed from feudalism. The new regime, avowedly determined to put into practice the economic system of socialism as outlined by Karl Marx, set for itself the primary task of raising production. The "drive" for economic growth professedly had a two-fold purpose. First, it was hoped that through an expansion in production the relatively low average standard of living then prevailing might be raised. Second, because of the belief that the new regime stood alone in a hostile world, it was hoped that through an expansion in production, particularly industrial production, the country's military position might be strengthened. Accordingly, measures were instituted which were intended to recast the economy from top to bottom. One major revision involved the virtual abolition of the institution of private property as it related to producer goods, the latter being brought under the ownership and management of the state. A second major revision involved the inauguration of overall economic planning, under which decisions affecting both the volume and type of production became the concern of a central planning authority.

The first period, extending from 1917 through 1921, and generally known as the period of War Communism, ended in a rather complete breakdown of the economy. Therefore, starting in 1922, a new approach was instituted, the so-called New Economic Policy (NEP). Initiated by Lenin, the NEP sought to pacify the populace, especially the land-conscious peasantry, by allowing private entrepreneurs to operate in some lines. Production revived during succeeding years, but the Soviet leaders, in keeping with their earlier pronouncements, emphasized that the ultimate objective continued to be the extinction of all private economic activity, the NEP being merely a transition phase preceding full collectivization. Accordingly, in 1928, the NEP was followed by the first of a series of Five-Year Plans, under which the level and composition of production was made subject to closer control and the eventual demise of the remaining vestiges of private enterprise was considerably hastened.

The fundamental problem faced by the State Planning Commission (or *Gosplan*) through the years has been one of how, by domestic

means, to promote rapid economic development. The plan of attack instituted operated essentially as follows. The Planning Commission was entrusted with the task of determining specific goals and the means for their achievement, a statement of which "ends" and "means" constituted a national economic plan. Such a plan, as exemplified by a Five-Year Plan, established a "quota" to represent the national income believed attainable in each of a series of years, along with the proposed manner of its utilization. Thus, a portion of national income was allotted to current consumption, while the remainder was set aside as a "surplus" (savings) to be "ploughed back" (invested) in order to replenish and increase productive capacity. In order to speed capital formation, consumption had to be drastically curtailed, or at least held at a level below that otherwise possible, a harsh procedure in a relatively low-income economy such as that of the Soviet Union, but potentially a very effective procedure from a developmental standpoint. The implementation of the national economic plan required a network of controls extending to the level of every production unit. In summary, decisions concerning production, consumption, and investment fell within the province of planning authorities, in contrast to the situation in a free-market economy where such decisions are made by many private persons acting independently of the government.

Foreign-Trade Planning

With insignificant exceptions, all foreign trade of the Soviet Union since 1918 has been conducted by agencies of the state and in conformity with the national economic plan. Since the basic objective has been to acquire as large a volume of goods as possible as rapidly as possible, the country has proven to be a reluctant exporter. In general, the volume of exportation has been restricted to the minimum amount needed to promote certain desired ends, either economic or political in nature.

From an economic standpoint, some exports are needed if imports not otherwise readily obtainable are to be acquired. In its attitude toward exports, however, the Soviet Union stands in sharp contrast to most other major countries. In the Soviet Union, exports are not necessarily looked upon as "desirable," nor do imports tend to be viewed as "undesirable"; in most other countries, in contrast, there is a tendency to look upon exports with greater favor than upon imports. The particular attitude of the Soviet Union may be attributed largely to the absence in that country of the pressures which commonly lead to an export surplus. Rather, observation of past conduct leads one to conclude that the Soviet Union is receptive to the idea of an import surplus for itself. Its stand on repara-

tions appears to bear out this point.[2] In any event, the country has the reputation of being the willing recipient of imports, particularly of industrial commodities, and its economic structure permits the ready absorption of such imports.

From a political standpoint, exports (and imports) provide a means to draw other countries more closely to one's own, or to prevent such countries from becoming oriented toward rival powers. Moreover, once trade has come into being, its threatened withdrawal may serve to promote the political ends of a country by undermining the "freedom of action" of a foreign country. Throughout its recent history, the Soviet Union has given evidence of its willingness to use foreign trade as a political instrument.

Foreign-Trade Organization

The formal organization for the conduct of foreign trade consists of a hierarchy headed by the Ministry of Foreign Trade. This agency controls the administration, planning, and coordination of all foreign-trade activities. Responsible to it is a complex group of organizations concerned with the physical operations of exportation and importation. Most important among these are the monopolistic import and export organizations, or *combines*, within the Soviet Union, and the trade delegations maintained abroad. The combines are of two general types. In a first category are those responsible for trade with a particular country or group of countries. For example, *Dalintorg* handles all trade with the Far Eastern countries, *Vostokintorg* handles all trade with Turkey, Iraq, and Afghanistan, and *Sovmongoltorg* handles all trade with the Mongolian People's Republic. In a second category are those responsible for special types of trade. For example, *Tekhnoeksport* handles exports of machinery, metals, and metal articles, *Tekhnopromimport* handles imports of machinery, *Soveksportfilm* exports Soviet films, and *Inturist* makes arrangements for the travel and accommodation of foreign tourists visiting the Soviet Union. In addition, trade delegations are maintained abroad, either to act as representatives of the Soviet combines, or to operate as separate agencies. The latter category includes *Amtorg*,[3] incorporated under the laws of New York state in 1924, which handles virtually all trade with the United States.

[2] Following World War II, the Soviet Union collected reparations valued at approximately $5 billion. The acquisitions consisted largely of capital equipment obtained in occupied areas, and undoubtedly contributed heavily toward the fulfillment of goals under the Fourth Five Year Plan. For a discussion of this point, see H. Schwartz, *Russia's Soviet Economy* (New York: Prentice-Hall, Inc., 1950), p. 289.

[3] *Amtorg* is the abbreviation for *Amerikanskaia torgovlia,* or "American trade."

State-Trading Operations

The practice of the Soviet Union of conducting its foreign trade through the channels of a state monopoly gives the country some distinct advantages, both economically and politically. From an economic standpoint, the state monopoly enhances the bargaining position of the Soviet Union. The country bargains as a unit, and there is no such thing as competition among individual buyers and sellers in negotiations carried on with foreign importers and exporters, who generally bargain in competition with one another. All other things being equal, the monopoly-monopsony position of the Soviet Union in its foreign-trade dealings enables it to "drive a hard bargain."

From a political standpoint, diplomatic, military, and other advantages may accrue to the Soviet Union through the use of foreign trade as an instrument of foreign policy. First, the deliberate stimulation of trade with particular countries may have the effect of orienting them in the direction of the Soviet Union. For example, the growth of trade between the Soviet Union and the satellite countries following World War II is widely accepted as evidence of an attempt by the Soviet Union to establish a close and lasting political tie between herself and the satellites. The relevant fact is that the proportion of all foreign trade of the Soviet Union carried on with the satellite countries of Eastern Europe rose from 11 per cent in 1938 to 83 per cent in 1951.[4] If a substantial amount of economic integration can be achieved, the likelihood of the smaller, relatively dependent countries going their separate ways is markedly reduced.

Second, when foreign trade is in the hands of the state, it may be timed and directed to create disruptive effects abroad. For example, the periodic "trade offensives" of the Soviet Union are widely regarded as attempts to draw countries into the Soviet orbit, or at least to "drive a wedge" between such countries and other countries. Illustrative of the latter, the "package" trade deals which the Soviet Union has on occasion during the post-World War II years dangled before the countries of Western Europe, e.g., Great Britain and France in 1953-54, have been offered at a time when these countries were experiencing difficulties in selling in the dollar area. To say the least, the ability of a country to correlate its trade relations with its foreign-policy aims tends to give it a tremendous advantage in the conduct of its foreign affairs. In fact, it is possible that a country may place such value upon this alleged advantage of state trading that price considerations as respects items traded come to

[4] UN, *Economic Survey of Europe Since the War,* Geneva, 1953, Table 77, p. 216.

be relegated to a secondary position. Needless to say, the specific ends of foreign policy are less likely to be served, or are left far more to chance, when foreign trade is in private hands and is conducted for private profit.

Third, the threatened stoppage of trade, when the decision to trade or not to trade rests exclusively with the government, constitutes a potent weapon, at least theoretically, which may enable a country to hold another country "in line." The use of trade as a coercive device, however, is dependent upon the extent of integration and the volume and nature of prevailing trade.

Finally, it is important to note that even if it can be shown that state trading does not hold economic or political advantages for the Soviet Union (an unlikely contention), the latter is obliged so to conduct its foreign trade since this system is in harmony with the state ownership and direction prevailing in the domestic economy.

The Pattern of Trade

Two important trends in the foreign trade of the Soviet Union are distinguishable. First, it appears certain (despite a paucity of published statistics on the subject[5]) that the volume of foreign trade, never particularly large either in absolute amounts or as a proportion of national income, is today considerably greater than in pre-World War II years (when exports and imports averaged only about 1 per cent of national income and when the total volume was about the same as that of Sweden or Switzerland, countries having populations but 5 per cent as large — Table 1, Chapter 2). A fundamental obstacle to a greater increase in the volume of trade is the continued inability of the Soviet economy to meet extensive export commitments in any great variety of commodities. With further growth in the domestic economy, however, this situation may eventually change somewhat.

Second, the foreign trade of the Soviet Union is today directed more toward the satellite countries of Eastern Europe and less toward the rest of the world than in pre-World War II years. In 1938, for example, 89 per cent of the foreign trade of the Soviet Union was with countries other than those of Eastern Europe, but in 1951 this proportion had fallen to 17 per cent.[6] Conversely, the satellite countries of Eastern Europe, whose economies are now patterned on the Russian "model," have come to be tied much more closely to the Soviet Union. For example, in 1937 the trade of Poland, Czechoslovakia, Rumania, and Bulgaria with the Soviet Union did

[5] Statistics, appearing largely in UN publications, are generally shown as percentages, rather than in absolute terms.

[6] UN, *Economic Survey of Europe Since the War,* Geneva, 1953, Table 77, p. 216.

not exceed 1 per cent of their total foreign trade, but in 1951 the proportions were 25, 28, 51, and 58 per cent, respectively.[7]

BRITISH BULK-PURCHASE CONTRACTS

During and after World War II, Great Britain engaged in a form of state trading through use of so-called *bulk-purchase contracts*. These contracts, or bilateral agreements, concluded between the British Government and other governments, or between the former and quasi-governmental agencies or private groups in other countries, have concerned the volume, type, and terms of importation and exportation during a specified period of time.

Bulk-purchase contracts were first introduced by Great Britain during World War II as a means to promote continued imports of foodstuffs and raw materials under difficult wartime conditions. Following the war, the practice of negotiating bulk-purchase contracts was continued and extended, especially during the years when the Labor party was in power. This political group was instrumental in introducing a relatively mild form of socialism, into which frame of reference the bulk-purchase contracts tended to fit comfortably.

Actually, completely aside from the receptivity of the Labor Government to measures designed to give governmental direction to economic affairs, the bulk-purchase contracts served several major purposes during the early postwar years. First, and most important, they served as a device for directing trade toward other sterling-area countries or other soft-currency countries and away from the dollar-area countries. In short, the contracts reflected an attempt to conserve relatively scarce dollars, but to do so by shifting trade to non-dollar countries rather than by curtailing the volume of trade. Second, they served to assure a fairly constant flow of imports at relatively favorable prices. The fact that Britain was able to bargain as a unit in the negotiation of the agreements tended to secure imports for her at prices somewhat more favorable than otherwise possible. The fact, also, that the agreements frequently extended over a period of years tended to assure an element of price stability. Third, they served to provide an element of protection for British producers or investors, or so it has sometimes been alleged, in that they directed trade to some extent toward those British dominions or territories in which British-owned or British-financed productive capacity was located.

In general, the purchase contracts called for the exchange of an array of goods, Britain generally exporting specified types and quantities of manu-

[7] *Ibid.*

factures in exchange for specified types and quantities of foodstuffs and raw materials of equivalent total value. While some contracts were scheduled to run for only a single year, most were of longer duration, extending from three to fifteen years. Under the Labor Government (following the war), there was a definite shift toward longer contracts, and a tendency to combine such contracts with long-term plans for the expansion of production with the aid of British capital. Whenever agreements were for longer than a year, provision was generally made for a periodic review of prices.

Over forty separate contracts were negotiated, covering trade with other Commonwealth countries and possessions, and with countries of Western and Eastern Europe, Latin America, and Asia. During the early postwar years, approximately one-half of all British imports (and well over one-half of all food and raw-material imports) were covered by such agreements. Some of the purchase contracts concluded include the following: (1) Under a 1948 contract, Britain contracted for New Zealand's entire export surplus of meat for seven years (except for pork, for which the contract ran only to 1952). Prices were subject to a maximum variation of 7.5 per cent annually. Also, under the contract, New Zealand's average export volume was scheduled for increase by some 15 per cent by 1955 with the aid of British capital, machinery, and materials. (2) Under a similar contract with Australia, Britain guaranteed to purchase that country's exportable surplus of meat, up to a specified ceiling, for fifteen years. (3) Under terms of a six-year contract concluded in 1949, Britain agreed to purchase 75 per cent of Denmark's exportable surplus butter, up to a specified maximum amount, subject to an annual price revision of 7.5 per cent each way. (4) A five-year trade and payments agreement with Argentina, concluded in 1949, provided for an approximate balancing of trade between the two countries. Under its terms, Britain agreed to import specified minimum quantities (or more) of beef, mutton, grain, and other food and raw-material products in exchange for petroleum, coal, chemicals, ships, iron and steel manufactures, machinery, and a variety of other manufactured goods. (5) A large-scale barter agreement concluded with the Soviet Union provided for British imports of wheat, corn, timber, potash, and canned fish in exchange for shipments of machinery, ships, rubber, and wool.

The fall of the Labor Government from power in late 1950, and its succession by a government under Conservative party leadership, brought a sharp change in policy. The Conservative party was committed to the overall policy of curbing the influence of government upon economic affairs. Accordingly, the foreign-trade policy put into effect by the Con-

servative party was to negotiate no new purchase contracts, but to honor all existing contracts. The Labor party has continued to favor "bulk buying where needed."[8]

STATE TRADING IN ARGENTINA

As we observed in the preceding chapter (Chapter 10), Argentina has long attempted to direct her foreign trade along desired lines by invoking a complex set of financial and legal regulations, important among them being her discriminatory multiple exchange rate system. In addition, the Argentine Government conducts a considerable volume of import and export trade on its own account through a state-trading organization, the Argentine Trade Promotion Institute (Instituto Argentino de Promoción del Intercambio, or IAPI). IAPI's major objectives include (1) the promotion of economic development, and (2) the derivation of governmental revenue. Economic development tends to be fostered through special favorable treatment accorded particular sectors of the economy by IAPI. Government revenue is derived from the profits which accrue on both exports and imports handled by IAPI. Additional purposes may also be served by IAPI, but these appear to be subsidiary to those cited.

On the export side, IAPI employs its strong bargaining position to buy substantial quantities of the domestic output of major agricultural products which are then marketed abroad, generally at substantially higher prices. For example, in the years immediately following World War II, when food shortages were common in many parts of the world, IAPI was well equipped to exploit the situation. Exports of basic agricultural products from Argentina thus occur either through IAPI, or as direct sales by domestic producers whose proceeds are then converted at the prevailing rate of exchange (a relatively unfavorable rate under the multiple exchange rate system employed). In either event, profit tends to accrue to the Government which might ordinarily have gone to producers or private exporters.

On the import side, IAPI handles all imports for government account. These are substantial, since the Government operates a number of large enterprises, such as the railway system. In addition, IAPI holds monopoly rights on the importation of a number of commodities, such as coal, petroleum, and rubber.

[8] Quoted from *Economic Policies of Britain's Labor Party,* Bulletin of British Information Services, January, 1951.

UNITED STATES GOVERNMENT IMPORTS AND EXPORTS

The United States, in contrast to many foreign countries, is deeply committed to a system of private enterprise, so that foreign trade continues to be regarded almost in its entirety as a proper field of activity for private traders. Only in special cases does the United States Government enter the field of foreign trade directly. Such exceptional cases include the following: (1) the sale abroad by the Government of surplus agricultural products acquired in the process of supporting agricultural prices, (2) the purchase abroad by the Government of goods and services under the "off-shore-procurement" phase of its military-expenditure program,[9] and (3) the purchase abroad by the Government (on occasion) of strategic raw materials for stockpiling (e.g., rubber and tin), such materials to be held in reserve for use in event of a national emergency.

The volume of imports and exports handled by the United States Government amounts to a relatively small proportion of total United States foreign trade. Significantly, however, this volume, when viewed in absolute terms, looms large in comparison to the foreign trade of other (and smaller) countries. For this reason, the policies pursued by the United States Government in its purchases and sales are of relatively great importance (and concern) to the world economy.

AN EVALUATION OF STATE TRADING

From a theoretical standpoint, there is no reason why trade carried on by a government cannot be just as advantageous, economically, as private trade. Government-directed trade, just as private trade, may, or may not, conform to the principle of comparative advantage. In practice, however, trade carried on by government tends to differ in some important respects from private trade.

First, a government is far more likely to be influenced by non-economic considerations in making its foreign purchases and sales than is a private trader. A private trader must show a profit, or at least break even, if he is to continue in business over an extended period of time. The decisions of a private trader, therefore, tend of necessity to be shaped by market factors; the private trader is guided by price and motivated by profit. In contrast, a government, especially if it enjoys a monopoly-monopsony

[9] The "offshore-procurement" program involves the purchase abroad by the United States of items which are then given as military aid to the country in which purchase was made or to another foreign country. The program is discussed at greater length in another connection in Chapter 21.

position in the foreign-trade field, may, if it so chooses, largely ignore price (and profit) considerations in order to channel trade so as to promote other ends, particularly its own political ends. The case of the U.S.S.R. adequately demonstrates this point. Once non-economic considerations come to influence the volume and direction of trade, however, it is not long before the principle of comparative advantage is pushed far aside. The end result is an economically poorer utilization of a particular country's (and the world's) productive effort. This is not to imply that a redirection of trade for non-economic reasons may not be supported on some grounds; the point is that a redirection of trade under state supervision frequently (if not always) conflicts with what is required when the principle of comparative advantage is the sole guiding principle behind the flow of trade.

Second, since a state-trading organization allows a country to bargain as a unit, import prices tend to be lower and export prices higher than when trade is in the hands of numerous private traders (i.e., a country may conceivably improve its terms of trade through the practice of state trading). A country is able to buy cheaper and sell dearer, especially when the government is the sole importer and exporter and when foreign exporters and importers are private persons acting independently of one another. The case then is a monopoly-monopsony organization in one country bargaining with various persons in other countries, the latter acting in competition with one another. The British bulk-purchase contracts illustrate the attempt of a country through state trading to obtain a relatively large volume of particular imports at relatively favorable prices over an extended period of time. When a country practicing state trading attempts to trade with countries which also have state-trading organizations, however, the resultant situation is one of monopolists bargaining with one another. The price advantage to a particular country then becomes far less clear-cut. The crucial element in the determination of prices in the latter case is the relative bargaining strengths of the various state-trading organizations.

Third, when importation and exportation occur through a state-trading organization, a gap between domestic prices and foreign prices frequently tends to be created or, if already existent, tends to be increased. For example, imports may be marketed domestically at prices below the world level, i.e., the government may deliberately incur a loss in order to subsidize domestic consumption. Again, exports may be sold at prices below those prevailing domestically, i.e., the government may deliberately incur a loss in order to remove "surplus" goods from the country. In either instance, the volume and price of traded items come to be determined by

forces other than those of a free market. Relative price differences cease to function as the basic guide in the allocation of productive effort. Under the circumstances, the manner in which resources and manpower come to be utilized may differ widely from what is appropriate according to the law of comparative advantage.

Technically, it is conceivable that a state-trading organization might operate simply as an intermediary between the domestic market and the foreign market. In practice, however, state trading appears to lead either to a rather complete disregard of free-market forces (as when state trading assumes political objectives) or to a substantial modification of them. In either case, the danger arises that productive effort will be utilized in a less economic manner than is possible in the absence of state trading. Lest this be construed as a blanket condemnation of state trading, it should be recognized that a government may properly set for itself numerous objectives, the attainment of some of which requires the pursuit of policies not always defensible on narrow economic grounds.

SUMMARY

State trading is said to exist when a government undertakes to carry on foreign trade on its own accord, either to the exclusion of private traders or alongside private traders. State trading has been motivated by various factors, two of which appear especially noteworthy. First, the economic system of socialism tends to put a government into all economic activity, including foreign trade. This factor largely accounts for the origin of state trading in the Soviet Union and in the so-called satellite countries of Eastern Europe. Second, countries experiencing external-payments difficulties frequently view state trading as a device to direct their imports away from particular countries and toward other countries. For example, Great Britain, under its post-World War II Labor Government, resorted to a system of bulk-purchase contracts in an attempt to divert imports from the dollar area, with which deficits prevailed, to non-dollar countries, with whom no similar foreign-exchange scarcities existed. Various other factors may, and do, serve to motivate state trading, but the foregoing factors appear to have been most basic, judged from a historical standpoint.

SELECTED REFERENCES

°Baran, P. A., "The U.S.S.R. in the World Economy," in S. E. Harris (ed.), *Foreign Economic Policy for the United States*. Cambridge: Harvard University Press, 1948.

Gordon, W. C., *The Economy of Latin America.* New York: Columbia University Press, 1950, Chaps. VIII, XV.

°Hoffman, M., "Problems of Trade between Planned Economies," *American Economic Review* (Papers and Proceedings), May, 1951.

Rafler, D. D., "Bilateral Trade Arrangements of the United Kingdom," *Foreign Agriculture,* October, 1949.

°Schwartz, H., *Russia's Soviet Economy.* New York: Prentice-Hall, Inc., 1950, Chaps. V, XIV.

12

International Cartels

IMPORTANT among the restrictions sometimes placed upon the production and marketing of commodities are those commodity controls exercised through international cartels and international commodity agreements. This chapter treats international cartels, and the following chapter treats international commodity agreements.

THE NATURE OF CARTELS

A *cartel* is said to exist when two or more producers engaged in the same line of trade, generally in the industrial field, agree to regulate production and sales so as to achieve monopoly-like ends. Ordinarily such agreements are initiated by the producers themselves, and they may in fact remain a closely guarded secret of the participants, but in other instances the agreements are government sponsored on grounds that they may serve as instruments of national policy. When the cartel operates internationally, including in its membership producers located in two or more countries, it is said to be an "international" cartel.

THE IMPORTANCE OF CARTELS

International cartels have been an important factor in international trade during recent decades, particularly in the period between World

War I and World War II, when conditions proved especially favorable for their development. According to a list prepared by the United States Department of Justice, the number of international cartels in existence at the outbreak of World War II totaled 179, of which 109 included American enterprises.[1] When it is recognized that major industries, including steel, chemicals, electrical products, and aluminum, were covered by cartel agreements, the importance of the latter in international trade may readily be visualized.

The disruption of trade with the outbreak of World War II served to sever many of the cartel connections built up during preceding decades. With the military defeat of Germany and Japan, in which countries were located some of the more important members of the major cartels,[2] the cartel movement received a further set-back. In consequence, international cartels were no longer as common immediately after the war as they were during the thirties.

While there is no general agreement as to the present importance of international cartels, it is nevertheless acknowledged that they are far from dead. Some evidence exists to the effect that there has been a substantial revival of cartel activity in the years since the close of World War II. It is known that some countries today openly foster cartel activity within their borders.[3] Full information concerning the *inter-country* connections which may exist between business groups, however, is lacking. Since participation by domestic firms in international compacts for the purpose of promoting monopoly-like ends is regarded as illegal in many countries, such private connections, if they do exist, are virtually always closely guarded secrets. It generally takes a major international crisis, such as a world war, to lay bare the connections which have been established. In the absence of such a crisis, there is no absolute certainty as to the prevalence of international-cartel activity. Finally, completely apart from the question of the present importance of international cartels, there is also the possibility

[1] C. D. Edwards, "International Cartels as Obstacles to International Trade," *American Economic Review*, Supplement, March, 1944, p. 330.

[2] German firms whose names figured importantly in the cartel movement include Krupp and I. G. Farben; in Japan, a relatively few firms acting in close harmony (the so-called *Zaibatsu*) controlled a relatively large proportion of economic activity.

[3] For example, two cartels, the "Société Générale de Belgique" and "Burfina," currently control an estimated one-half of the mining, industry, and commerce of Belgium and her African possessions and, therefore, a large portion of the trade between these areas and the rest of the world. The Belgian government actively and openly supports such cartels; specifically, if a majority of the producers proposes to regulate the output of a given industry, the government is legally required to see to it that all producers conform. Moreover, new companies are prohibited from starting operations in a cartelized field unless their entry is approved by others already in the field.

that they may assume greater importance in the future if economic and political conditions prove conducive.

In evaluating the importance of international cartels as an impediment upon international trade, one authority has expressed the opinion "that the injury inflicted by tariffs on domestic competition and American foreign trade has been several times greater than the effect of cartels; that current agricultural policy is likely to be much more damaging to exports than the total of American cartel practices; that inter-governmental commodity agreements will reduce the volume of postwar world trade more drastically than international cartels; and that the problem of dealing with state trading monopolies will far overshadow the difficulty of dealing with cartels." He then adds, "This judgment does not deny the importance of the international cartel problem."[4]

THE DEVELOPMENT OF CARTELS

If past experience is a guide, international cartels tend to arise under either or both of two sets of conditions. First, a high degree of monopoly-like action among domestic producers frequently serves as a preliminary step in the international cartelization of an industry. If curtailment of competition proves beneficial to members of an industry within a given country, it follows that an extension of monopoly-like action beyond the confines of the single country may carry with it additional benefits for the producers concerned.

Second, the existence of productive capacity in excess of current consumption frequently provides the stimulus for the conscious restriction of an industry. For example, under the stress of war (or in consequence of an extended period of "unusually high" prosperity) added productive capacity is brought into being, but when economic activity returns to "normal" some of this capacity tends to prove "excessive." International combination then reflects an attempt on the part of members to "share" a diminished market.[5] Once such agreements are arrived at, however, they frequently tend to persist, and even grow, long after the depressed conditions which motivated them cease to exist.

[4] By permission from *Controlling World Trade*, by E. S. Mason (New York: McGraw-Hill Book Company, Inc., 1946), pp. 28-29.

[5] See K. E. Boulding, "In Defense of Monopoly," *Quarterly Journal of Economics*, August, 1945, for an excellent discussion of the relationship between the growth of monopolies and the presence, or absence, of deflation. See esp. pp. 530-531, 541-542.

THE OBJECTIVE OF CARTELS

The primary objective of an international cartel is to maximize the profits of its members. Instead of acting independently, normally competitive firms agree to coordinate their activities in a manner which enables the industry, and the individual firms, to obtain monopoly profits. This objective may be achieved by engaging in any one or more of five possible practices.

1. **Control over Prices.** International cartels typically resort to price-fixing agreements in order to maintain prices at levels above those likely to prevail under competition. Price wars often occur prior to the cartelization of an industry, and may pave the way for the formation of a cartel, but once a cartel has been formed, high and stable prices are characteristic. While prices may be slashed on occasion to prevent the successful entry of a new firm, the rule appears to be prices above competitive levels, infrequent price reductions, and price increases whenever circumstances permit. The extent to which price may be raised is illustrated by the following example cited in a United States Senate Subcommittee report:

> Tungsten carbide is a hard-metal composition of great industrial importance in cutting tools, extrusion dies, and wear-resistant surfaces. It was sold in the United States in 1927-28 at $50 per pound. At that time General Electric and Friedrich Krupp Aktiengesellschaft formed an agreement by which their patents were pooled. General Electric was given control of the sale price in the United States, and Krupp was obligated to observe this price upon its imports. Thereupon the United States' price rose promptly to a maximum of $453 per pound. During most of the thirties the price range was from $225 to $453, and in 1940 the maximum price was still $205 per pound. In April 1942, after an indictment under the antitrust laws, the price ranged from $27 to $45 per pound.[6]

2. **Impairment of Quality.** Because an international cartel is a monopoly, the incentive to improve quality is reduced, and buyers have few safeguards against low quality short of an outright refusal to purchase. In speaking of this situation, the following example involving the electric-light-bulb industry during the late thirties has been cited:

[6] C. D. Edwards, *Economic and Political Aspects of International Cartels*, Monograph No. 1, pp. 12-13. Subcommittee on War Mobilization of the Committee on Military Affairs, U. S. Senate, 1944. This report contains a wealth of material on international cartels, including numerous case studies of cartels operating during the thirties. A recent study by the UN, *Restrictive Business Practices*, Supplement 11A, New York, 1953, also contains much pertinent material on the cartel question.

> The cartel arrangements concerning electric lamps illustrate the impunity with which quality may be degraded. Under international cartel agreements the American market has been reserved for the American manufacturing companies, General Electric and Westinghouse, and markets in other parts of the world have been allocated. Protected from foreign competition, American manufacturers have attempted to increase their business by reducing the durability of their light bulbs. They were able to find an excuse for their action in the fact that the efficiency of a light bulb is in inverse ratio to its length of life; but they were careful not to inform consumers of the decision to sacrifice durability, nor to allow an opportunity for the buyer to choose between more efficient and more durable bulbs.[7]

3. **Allocation of Trade Territories.** Another common cartel practice is the allocation of trade territories, a practice which enables members to acquire and maintain a monopoly position in markets especially suited to them. Members customarily agree to respect the trade territories of one another, and generally sacrifice exports to some countries in return for a free hand at home or in some other trade area. For example, an agreement in the chemical field during the thirties operated as follows:

> With exceptions for certain special products duPont is granted exclusive rights in the United States and Central America and Imperial Chemical Industries exclusive rights in the British Empire except Canada. The two companies have agreed that they will exploit the Canadian, Brazilian, and Argentine markets through jointly owned subsidiaries. Both companies remain free to sell in other portions of the world.[8]

4. **Restriction of Supply.** Another common practice by means of which international cartels restrict competition and control prices is through the fixing of absolute limits upon the amount members may produce, sell, or export. It has been common for cartels to assign quotas to members, to levy fines against those exceeding their quotas, and to distribute profits according to a formula previously agreed upon. In the past such arrangements to limit supply have most frequently arisen during periods when declining markets have threatened to create excess capacity in the industry, or when there has been a likelihood of new capacity.

As an example of the restriction of supply, during the late 1920's the international steel cartel, comprised of producers in a number of European countries, including France and Germany, sponsored an agreement under terms of which production quotas based on previous output were assigned

[7] *Ibid.*, p. 16.
[8] *Ibid.*, p. 21.

to members. Members not producing their full quotas were paid from a fund maintained for the purpose, and those exceeding assigned quotas were subject to fines. Export quotas were handled in a similar manner.[9]

The restriction of productive capacity through cartel pressure is vividly illustrated by developments in the American magnesium industry prior to World War II. According to terms of an agreement between the Dow Chemical Company and the Aluminum Company of America, the latter closed its magnesium plant, thereby giving Dow a domestic monopoly. In order to forestall the establishment within the United States of other plants producing magnesium, potentially a substitute for aluminum, I. G. Farbenindustrie became party to an arrangement under terms of which Alcoa agreed to pool its magnesium patents, and Dow agreed to limit its production of magnesium to 4,000 tons annually. Under the high prices maintained, production fell short of this amount. Any production not marketed domestically was scheduled for purchase by I. G. Farben. As a result of these arrangements, the production of magnesium in the United States was severely restricted, Alcoa prevented the development of magnesium as an important substitute for aluminum in the United States, Dow avoided the construction of competitive plants which might have undermined prevailing monopoly prices, and I. G. Farben was assured of the continuation of its magnesium monopoly in other parts of the world.[10]

5. **Retardation of Technological Change.** Examination of the past practices of cartels indicates that they on occasion deliberately retard technological change. Such retardation comes about either through their attempts to delay the development of substitutes likely to permanently reduce the market for an established product, or through their attempts to delay investment in new and more modern plant and equipment until existing facilities have been fully depreciated.

Cartel members, in practice, are more likely to promote new uses for established products than to develop new processes or new products. This is not to imply that research is not undertaken. Since cartel arrangements are frequently based upon patent monopolies and the interchange of patent licenses, members are interested in promoting invention at least to the extent necessary to maintain and extend their patent position. The uses to which such discoveries are put, however, are generally closely controlled by the cartel. The situation thus tends to be a mixture of emphasis upon research, joint use of new processes, and efforts to prevent the use of new processes in ways harmful to prices or profits.

[9] *Ibid.*, pp. 24-25.
[10] *Ibid.*, p. 31.

RAW-MATERIAL CONTROLS

International cartels have most frequently developed in those industries in which the process of manufacture may be patented or in which the finished product may be protected by trade-mark, thereby making it possible to establish a monopoly not easily challenged. Nevertheless, cartels are not limited to manufacturing industries, but have also been used to control the production, sale, and exportation of basic raw materials, such as rubber, tin, nitrates, diamonds, mercury, potash, camphor, quebracho, and others. Conditions generally necessary for the establishment of a cartel among producers of raw materials include a relative scarcity of the basic raw material, a source of supply confined to a relatively small number of countries, or the control of output by a relatively few producers. If a relatively large number of producers is involved, government cooperation or leadership generally proves necessary for the formation of a cartel. A government may prove to be a willing sponsor, however, in cases where the commodity in question is a major product and is destined largely for export, since it has a direct interest in maintaining high and stable prices which improve the terms of trade and promote national prosperity.

Cartels in the raw-material field are not always successful. The resultant decrease in production and increase in prices frequently serves to bring forth additional output from competitive producers and areas not included in the cartel agreement. In other instances, the development of a synthetic provides an effective substitute. For example, under the Stevenson Plan, introduced in 1922 by the British Government to restrict the output of rubber in the Malay States, the price of rubber was raised from 13¢ to $1.03 per pound within a few years. The plan, however, proved vulnerable as producers in the Dutch East Indies, who were not covered by the cartel, increased their output in response to the higher prices. After prices had fallen to a low level during the Great Depression, a new cartel was formed, this time including in its membership producers located in British Malaya, the Dutch East Indies, French Indochina, and Thailand. This cartel, known as the International Rubber Regulation Agreement, covered about 98 per cent of world output, and succeeded in raising the price from 3.4¢ to 19.3¢ per pound between 1932 and 1937, and to an average in excess of 22¢ in 1941. Since the United States normally consumed about one-half of all crude rubber produced, the exploitative power wielded over the American consumer by the cartel was quite significant. The events of World War II, however, caused the second attempt at cartelization to fail also. As the supply of natural rubber was cut off during the war, the United States developed and produced synthetic rubber. At

the end of hostilities, therefore, the scope for independent action by the producers of natural rubber was severely limited by the competitive threat posed by the synthetic product.

The experience of the nitrate industry was somewhat similar. Chile for many years found herself in the enviable position of having a virtual world monopoly in natural nitrates. The industry proved a profitable one, and the economy of Chile came to be heavily dependent upon the mining, semi-processing, and exportation of this mineral. The 1920's, however, witnessed the development of synthetic nitrates, which development completely broke the Chilean monopoly, causing severe economic repercussions upon the country's domestic economy.

ATTITUDES TOWARD CARTELS

The American attitude has long been aligned against international cartels. The feeling has been that cartels, in common with some other forms of monopoly organization, exert an undue restraint upon trade and hence are not in the public interest. This opposition to monopoly led to the enactment of a series of laws, beginning with the Sherman Anti-Trust Act in 1890. The illegality of certain forms of combination operating in restraint of trade extended as well to cover the participation of American firms in international cartels, with one exception. Because the existence of foreign cartels tended to exclude American exports from certain markets, and because foreign cartels tended to depress the prices of particular American export products by avoiding competition among themselves in making purchases, the United States enacted the Webb-Pomerene Act in 1918. This act stipulated that domestic firms were henceforth free to combine among themselves or with foreign firms for the purpose of promoting the exportation of American products, provided such agreements were not in restraint of trade within the United States. A number of "export cartels" arose under this law. There is ample evidence, however, that American firms have on numerous occasions gone beyond the provisions of the Webb-Pomerene Act in order to combine with foreign firms on matters affecting domestic business as well. Some of these cases have been cited in the preceding pages. As a general rule, American participants sought to preserve the secrecy of these arrangements, partly in order to avoid adverse publicity and partly to safeguard against prosecution under existing anti-trust legislation. It took the events of World War II to uncover some of the more intricate arrangements which had been worked out between American and foreign firms, many of the latter firms being located in the then-enemy countries.

In contrast to the American attitude, the traditional European attitude

has been tolerant of cartels, viewing them merely as another form of business organization. Not only have cartels been tolerated, but they have in fact in some notable cases been openly promoted or sponsored by governments. This was especially true of Germany during the interwar period when cartels were developed and moulded to serve the economic and political ends of the government. Events associated with World War II, however, drew attention to the international status and vast economic power of cartels, with the result that considerable opposition arose to their continuation or revival. The immediate postwar European attitude, therefore, tended to conform much more closely to the American attitude. The apparent about-face proved short-lived, for within five years of the termination of hostilities a limited revival of cartel activity had already occurred in Western Europe. It is significant that this development was either sanctioned or supported by the national governments in question.

THE PROS AND CONS ON INTERNATIONAL CARTELS

Among the arguments sometimes advanced in behalf of international cartels, two merit special consideration. First, it has been alleged that international cartels may promote lower costs of production by virtue of their large-scale operations, the pooling of patents and "know-how," the elimination of "wasteful" competition, and the abandonment of high-cost productive capacity, and that these lower costs of production may then be passed on to consumers in the form of lower prices. This argument is weak from beginning to end. International cartels ordinarily continue to grow even when they are far beyond the size where additional growth yields further economies of scale. In fact, there is reason to doubt that the desire for lower costs is even a basic motivation of cartel organization. For instance, the record indicates that cartels tend to pursue a pricing policy designed to protect high-cost productive capacity, rather than to eliminate it. Moreover, the absence of competition hardly makes for a situation in which there is a premium upon efficiency. Even if the possibility of lower costs is granted, there is no compelling reason why a cartel must willingly pass such benefits on to consumers in the form of either lower prices or improved quality.

Second, it has been alleged that combination is a necessary procedure for coping with the problem of excess capacity. To the extent that cartels arise during periods of "slack" business conditions, they are frequently pictured as being defensive rather than predatory in nature. The argument relates restriction of supply to the elimination of excess capacity, the claim being made that only capacity which is economically "excessive" or "useless" is eliminated. This argument is weak in that it is designed

to justify the existence of cartels under depression conditions, but the fact remains that once formed, cartels continue to pursue policies of restriction long after prosperity has returned. In this respect cartels act in a fashion similar to those "infant" industries which seek to retain permanently the tariff protection initially extended them on a temporary basis.

The basic economic argument against an international cartel is the same as that commonly made against any unregulated monopoly, namely, monopoly tends to bring about a lower output and a higher price than does competition. The ultimate consumer is hurt, while monopoly profits accrue to a relatively few persons.

From an overall standpoint, there are two additional criticisms to be made against international cartels. First, when international cartels become widespread the total volume of international trade tends to be reduced. This is the case because (*a*) the smaller output and higher price under monopoly leads to less sales, and because (*b*) the practice of international cartels of apportioning sales territories so as to give exclusive rights in the home market to domestic firms tends to reduce the amount of trade which crosses national boundaries. Second, when international cartels become widespread there tends to be a less economic utilization of the world's manpower and resources. This is the case because (*a*) there is no effective competition to compel efficiency or to reward low-cost producers, and because (*b*) the allocation of productive capacity and production quotas is intended to serve purposes other than, or in addition to, the maximization of productive efficiency.

PUBLIC POLICY TOWARD INTERNATIONAL CARTELS

If international cartels are deemed undesirable, what may be done about them? Of several possible approaches, three appear basic. The first approach suggests that a country unilaterally attack international monopoly through its insistence upon competition within the domestic economy. The policy of the United States since 1890 has been based upon this idea. The weakness of this approach is that it cannot serve to make every price a competitive price, no matter how well the anti-monopoly laws are enforced. When all or most of the domestic consumption of a commodity is produced domestically, a government may hope to protect its consumers by requiring that the domestic producers remain aloof from any connections which may lead to a restraint of trade. When all or most of the domestic consumption of a commodity arises abroad, however, a government can do little to protect its consumers, since it has no jurisdiction over what happens abroad. The result is that in a large

and relatively self-contained country like the United States, a unilateral attack upon monopoly may go far toward breaking the connections of international cartels. In contrast, in those countries which are largely undiversified and heavily dependent upon imports, the unilateral approach can offer little protection against foreign or international monopolies.

A second approach suggests the regulation of international cartels through international cooperation. For example, the Charter of the proposed (but dormant) International Trade Organization, a post-World War II development, contained a general policy statement on cartels, a statement designed to serve as a guide for member countries in the formulation of their individual sets of regulatory provisions.[11] Again, in 1951 the United Nations Economic and Social Council adopted a resolution, proposed by the United States delegation, which asked member countries to take measures to prevent "restrictive business practices," private or public, affecting international trade.[12] To prove effective, an international approach requires that there be rather complete agreement among participants as to precisely what needs to be done. In practice, however, political obstacles make it difficult to achieve international agreement in this connection beyond the adoption of statements of principle. The necessary implementing legislation within individual countries is frequently not forthcoming; even when elaborate legislation exists, the will to enforce the legislation is frequently not very strong. Significantly, sovereignty being what it is, there is a distinct limit to what can be done to compel action if a particular country chooses not to act on its own accord.

A third approach suggests the elimination of the conditions which foster the formation of cartels. If violent cyclical fluctuations can be prevented, so it is argued, excess capacity is less likely to arise; with the elimination of the problem of excess capacity, one of the more important motivations for the formation of cartels ceases to exist. Proponents of this approach stress the importance of high-level economic activity, and generally emphasize the "key" role of the major industrial economies in creating and maintaining world prosperity.

SUMMARY

International cartels are private or government-sponsored agreements between normally competitive producers located in two or more countries, which agreements have as their purpose the control of production, sale, and exportation of a commodity in order to achieve monopoly-like ends.

[11] Art. 50-1.

[12] G. Patterson and J. N. Behrman, *Survey of United States International Finance, 1951* (Princeton: Princeton University Press, 1952), p. 187n.

International cartels are generally found in the industrial field, but they may also exist in the raw-material field when the particular commodity is in relatively scarce supply, is concentrated in a relatively small number of regions, or is produced by relatively few producers. International cartels frequently arise during periods of declining demand when the industries concerned are faced with excess capacity.

The central objective of international cartels is to reduce competition so as to enable members to obtain monopoly profits. This objective leads to any one or more of the following practices: (1) price-fixing, (2) quality deterioration, (3) allocation of trade territories, (4) control over supply, and (5) retardation of technological change.

International cartels are subject to the basic economic criticism that they lead to smaller output and higher prices than are likely to prevail under competition. They also tend to reduce the volume of international trade and to result in a less economic utilization of the world's resources and manpower.

If international cartels are deemed undesirable, the following methods have been suggested for their control or elimination: (1) the unilateral enactment and enforcement of anti-monopoly laws, (2) an international attack along uniform lines, or (3) a global full-employment program designed to prevent the periods of excess capacity during which cartels are prone to arise.

SELECTED REFERENCES

°Edwards, C. D., *Economic and Political Aspects of International Cartels*, Monograph No. 1. Subcommittee on War Mobilization of the Committee on Military Affairs, U. S. Senate, 1944.

———, "International Cartels as Obstacles to International Trade," *American Economic Review*, Supplement, March, 1944.

°———, ed., *A Cartel Policy for the United States*. New York: Columbia University Press, 1945.

Hexner, E., *International Cartels*. Chapel Hill: University of North Carolina Press, 1946.

°Mason, E. S., *Controlling World Trade*. New York: McGraw-Hill Book Company, Inc., 1946, Part I.

Stocking, G., and M. W. Watkins, *Cartels in Action*. New York: The Twentieth Century Fund, 1946.

———, *Cartels or Competition?* New York: The Twentieth Century Fund, 1946.

°United Nations, *Restrictive Business Practices* (Supplement No. 11 and Supplement No. 11A), New York, 1953.

13

International Commodity Agreements

IN ADDITION to regulation by cartels, the production and marketing of commodities may also be regulated through international commodity agreements.

THE MEANING OF INTERNATIONAL COMMODITY AGREEMENTS

International commodity agreements are intergovernmental arrangements concerning the production and trade of certain basic raw-material products, agricultural or mineral. International commodity agreements differ from international cartels chiefly in that (1) they ordinarily concern commodities produced by many rather than a relatively few producers, and (2) they ordinarily are framed only following consultation between representatives of both producer and consumer countries. Important commodities covered by such agreements include coffee, sugar, and wheat.

THE NATURE OF COMMODITY PROBLEMS

International commodity agreements arise because freely competitive world trade in particular primary (raw material) commodities leads to market conditions deemed undesirable by both producers and consumers.

Table 19

Production of Raw Materials, by Countries, 1952

Raw Materials	Leading Producers 1	%	2	%	3	%
Minerals						
Aluminum	U.S.	41	Canada	22	U.S.S.R.[1]	12
Antimony	Bolivia	21	China [1]	17	U. of So. Africa	16
Chromite	Turkey	19	U.S.S.R.[1]	19	U. of So. Africa	18
Coal	U.S.	24	Germany	19	United Kingdom	16
Copper [3]	U.S.	31	Chile	15	N. Rhodesia	12
Gold [3]	U. of So. Africa	34	U.S.S.R.[1]	28	Canada	13
Iron Ore	U.S.	33	U.S.S.R.[1]	17	France	14
Lead	U.S.	24	Mexico	13	Australia	11
Manganese Ore [3]	U.S.S.R.[1]	32	India	17	U. of So. Africa	11
Mercury [3]	Italy	37	Spain	26	Yugoslavia	10
Molybdenum [3]	U.S.	89	Chile	7	Norway	1
Nickel	Canada	73	U.S.S.R.[1]	14	N. Caledonia	6
Petroleum [3]	U.S.	51	Venezuela	15	U.S.S.R.[1]	7
Silver	Mexico	24	U.S.	19	Canada	12
Tin	Malaya	33	Indonesia	20	Bolivia	19
Tungsten Ore [3]	China	32	U.S.	11	. . . . .	
Vanadium (1947)	U.S.	55	Peru	25	S. W. Africa	11
Zinc	U.S.	37	Canada	9	Belgium	9
Foodstuffs						
Cocoa (1952-53 crop year [3])	Gold Coast	34	Nigeria	14	Brazil	13
Coffee (1952-53 [3])	Brazil	46	Colombia	19	El Salvador	4
Rice (1952-53 [3])	China	29	India	24	Pakistan	8
Sugar (1952-53)	Cuba	16	U.S.[2]	12	U.S.S.R.[1]	7
Wheat (1952-53)	U.S.	17	China	11	Canada	9
Other Products						
Cotton (1952-53 [3])	U.S.	44	U.S.S.R.[1]	12	India	8
Rubber (natural)	Malaya	42	Indonesia	33	Ceylon	5
Tobacco [3]	U.S.	31	China	17	India	6
Wool [3]	Australia	29	Argentina	9	New Zealand	9

[1] Estimated; may be subject to greater margin of error than other percentages shown.
[2] Includes Puerto Rico and Hawaii.
[3] Preliminary.

Source: Computed from data appearing in *Commodity Year Book, 1954* (prepared and published by Commodity Research Bureau; basic data obtained from governmental agencies, commodity exchanges, trade associations, and other organizations).

An analysis of the supply-and-demand conditions which characterize primary products readily indicates why a free market produces unique results in their case, and why governmental intervention is sought on occasion in order to regulate their output and sale.

On the supply side, particular circumstances surrounding the production of primary products tend to create a situation under which adjustment to changed market conditions becomes difficult. The central cause of this difficulty is the relatively large number of producers. For instance, production of many of the more important primary products is carried on in a number of countries, each of which tends to be heavily dependent upon the production and exportation of the product in question, although the total exportation by any single country frequently represents only a small fraction of world trade in the particular commodity (Table 19). Moreover, within each country there ordinarily are many producers, no one of whom produces enough to affect the total situation on his own accord. In the absence of a procedure for coordinating individual actions, all the individual producer can do is to follow his natural inclination, in this case meaning all-out production. Such action on the part of all, however, may serve to "ruin" the industry, especially if demand is relatively inelastic, as it is for primary products (at least during short-run periods). Thus, if the supply of primary products entering world markets shows a significant increase during a given period, the conditions of inelastic demand quickly lead to a marked decrease in the price of the commodity. Such a price decrease, however, tends not to be followed by a curtailment of supply, since individual producers have little incentive to act singly in an attempt to restrict supply. The result is that primary production is subject to periodic overproduction (relative to demand), leading to price instability. This situation readily becomes a matter of national concern, not only because the welfare of many people is directly involved, but also because the economic well-being of other sectors of the economy, and of the economy as a whole, may be heavily dependent upon the prosperity of the primary-goods producers.

In addition to problems of a short-run nature, problems of a long-run nature may also arise and serve to aggravate matters for raw-material producers. Improvements in technology frequently are paralleled by rising output, but demand ordinarily tends not to keep pace. While long-run improvements in income levels and living standards serve to raise total demand somewhat, the consumption of primary products typically rises much more slowly than does income capacity (i.e., the income elasticity of demand for primary products is less than 1). Thus, in addition to the problem of short-run price instability, there arises the much more serious

problem of long-run overproduction (relative to demand), involving chronic surpluses and a fairly steady downward pressure upon the prices of primary products. The existence of the peculiar long-run pressures to which primary products are subject provides part of the basis for the conclusion frequently drawn that the terms of trade tend over time to move against raw-material-producing countries and in favor of industrial countries,[1] a situation commonly viewed with alarm in the predominantly raw-material-producing countries. It is quite understandable why countries, when faced with the possibility of a gradual deterioration in their foreign-exchange positions, choose to concern themselves with the plight of private producers and exporters in the raw-material field.

In short, the forces of supply and demand operating as they do, a free market in primary products leads to short-run market instability and (perhaps) to long-run market deterioration. Producing countries are not always satisfied with the results which flow from the operation of free-market forces. Rather, they frequently are inclined to exert control over the conditions surrounding the production and sale of their major products. Attempts at control fall into two major categories. The first emphasizes unilateral domestic action, while the second emphasizes international regulation of production and marketing.

DOMESTIC CONTROL OVER COMMODITIES

Unilateral action by a country may take any one of several forms. It may involve the payment of subsidies, direct or indirect, to producers in order to offset adverse prices, the adoption of price-support schemes, the imposition of restrictions against competitive imports, or other actions. Such actions, however, commonly provide little more than temporary relief. Basically they concern themselves with symptoms rather than with the disease, a conclusion drawn from the fact that the fundamental task of re-allocating productive effort is generally sidestepped. In fact, the palliatives named may actually serve to intensify commodity problems. For example, domestic measures which restrict output and raise price may stimulate foreign production and thereby create import competition, while export subsidies and import quotas may lead to foreign retaliation.

[1] For an elaboration of this point, see UN, *The Economic Development of Latin America*, New York, 1950, pp. 8-14; see esp. Table 1, p. 9. For a contrary view which regards the actual deterioration of the terms of trade of raw-material-producing countries during the decades immediately preceding World War II as merely a short-run phenomenon, see C. Clark, *The Economics of 1960* (London: Macmillan & Co., Ltd., 1942), p. 99. It can, of course, be logically argued that in the long run, as the spread of economic development causes a growing proportion of the world's productive effort to be devoted to non-raw-material production, the terms of trade will move in favor of the raw-material-producing countries.

Perhaps most significant among the schemes for the domestic control of primary commodities is that of *buffer stocks*. The buffer-stock approach visualizes the promotion of relative price stability through additions of a primary commodity to a governmentally maintained pool whenever the commodity is overly abundant, followed by withdrawals from the pool whenever the commodity is in short supply. Through its willingness to purchase substantial quantities of a commodity at a designated price, the buffer-stock authority automatically sets a floor below which prices cannot fall. On the other hand, the ability to place a commodity upon the market at a given price is tantamount to fixing a price ceiling for the product. Relatively small additions to or withdrawals from buffer stocks under reasonably normal circumstances theoretically prove of sufficient strength to maintain relative price stability.

While the buffer-stock idea has an economic basis, it also has practical drawbacks. First, the storage of buffer stocks may prove costly, or even impractical in the case of perishable products. Second, administration may prove difficult because of differences in opinion as to what market price buffer-stock authorities are warranted in supporting. While it is technically possible from the standpoint of economic and statistical knowledge to make decisions concerning the timing and pricing of commodity purchases and sales in a manner leading to approximate price stability with only a moderate accumulation of buffer stocks, and indeed to allow for long-run changes in supply and demand in making these decisions, there nevertheless is an ever-present danger that authorities may find it difficult to resist the pleas of interested parties seeking "favorable" treatment. If authorities succumb under pressure to the maintenance of prices above the long-run equilibrium level, more goods are likely to be added to buffer stocks than can successfully be disposed of in domestic markets during periods when the free-market price rises above the controlled minimum. The surplus stocks acquired in this manner either may be allowed to accumulate indefinitely, or, more likely, may be "dumped" abroad at prices well below the domestic level. In either case, buffer stocks no longer merely provide a means to "iron out" short-run instability, but serve to underwrite excessive productive capacity, preventing long-run adjustments within the industry and enriching some producers at the expense of consumers and taxpayers. Unless a way can be found to ensure sustained pressure-free administration, there is little hope that buffer-stock schemes may be successfully employed in the elimination of commodity instability. Third, buffer-stock schemes are subject to the criticism that they are ordinarily undertaken on a unilateral basis, but production of the particular commodity normally occurs in a number of countries, no one of

which produces enough to dominate the market. Consequently, a buffer-stock scheme can perhaps hope to ensure reasonable price stability in the domestic market, but it cannot help capture an export market, nor can it assure favorable or stable prices in the export market. Theoretically, two or more potentially competitive producing countries may coordinate their actions under separate buffer-stock plans, but friction may develop as independent domestic policies lead to a competitive scramble for export markets. Greater success in the international control of raw materials is perhaps possible under a second basic approach, namely, through the negotiation of international commodity agreements.

INTERNATIONAL CONTROL OVER COMMODITIES

International commodity agreements are intergovernmental agreements between leading producing countries, or between them and leading importing countries as well, and are concerned with matters relating to the production and marketing of primary commodities. Such agreements arise either as an outgrowth of private arrangements or as the result of deliberate government policy. Since private arrangements tend to be weak because of limited participation or inconclusive control over participants, interested parties are prone to seek the support of government in order to extend coverage and strengthen control. Cases in which international commodity agreements have evolved from private cartels include rubber, tea, and tin. More generally, however, international commodity agreements grow out of the attempts of individual countries to deal with the problems of surplus production and unstable price in those lines of primary production in which the existence of relatively large numbers of producers makes private agreement difficult, if not impossible, to effect. Cases in which international commodity agreements evolved through government sponsorship include coffee, sugar, and wheat.

When an international commodity agreement includes only producing countries, the objective generally is that of regulating production and exportation so as to stabilize price, or perhaps to raise it. Because such action is apt to invite retaliatory measures on the part of the major importing countries, possibly eventuating in the breakdown of the agreement, exporting countries frequently seek to give the leading importing countries a voice in the proceedings. The hope of producing countries for a high and relatively stable price then comes to be pitted against the desire of major importing countries for a steady flow on reasonable terms of the particular primary commodity in question. The result, so it is generally argued, is an agreement which tends to be more representative of the various interests and which, therefore, is ordinarily more enduring.

THE INTERNATIONAL WHEAT AGREEMENT

International commodity agreements are fairly common, and have been so since the 1920's. Their basic nature may perhaps be best understood through an examination of one of them, the International Wheat Agreement of 1953.[2] This agreement, with some modifications, represents an extension for the three crop years ending July 31, 1956, of the arrangements concerning the international sales and purchases of wheat previously established by the International Wheat Agreement of 1949. The objective of the agreement, as stated in an opening section, is to "assure supplies of wheat to importing countries and markets for wheat to exporting countries at equitable and stable prices." The agreement is subscribed to by forty-five countries, four exporting countries (the United States, Australia, Canada, and France) and forty-one importing countries.[3]

Major provisions of the 1953 agreement include the following:

First, each exporting country agrees to sell a specific quantity of wheat and each importing country agrees to purchase a specific quantity. The total guaranteed sales are equal to the total guaranteed purchases. The total guaranteed sales of 595 million bushels per crop year are apportioned among the various exporting countries, e.g., 270 million bushels for the United States, 250 million bushels for Canada, 75 million bushels for Australia, and 0.4 million bushels for France. Guaranteed purchases of 595 million bushels per crop year are apportioned among forty-two importing countries, e.g., 177 million bushels for the United Kingdom, 55 million bushels for Germany, 55 million bushels for India, and lesser amounts for other member countries. In consequence of the failure of the United Kingdom to ratify the revised agreement (because of an objection to the maximum price established[4]), the effective total guaranteed sales and purchases are 177 million bushels per crop year below those previously indicated, and the guaranteed sales of each of the exporting countries are also proportionally lower. The agreement provides further that the guaranteed quantities may be increased or that parts of the guaranteed

[2] The full text of the agreement appears in the *Congressional Record*, U. S. Senate, 83rd Congress, 1st session, July 13, 1953, pp. 8891-8900.

[3] According to the procedure followed, the agreement was to take effect on August 1, 1953, provided ratifications were deposited on or before July 15, 1953, by governments responsible for not less than 50 per cent of the proposed guaranteed purchases and not less than 50 per cent of the proposed guaranteed sales. All countries initially proposed for membership, with the sole exception of the United Kingdom, ratified the agreement by the date specified.

[4] In preference to committing herself to a long-term agreement at the stated prices, Great Britain chose to remain outside the agreement and to take a chance on the possibility of a marked decline in wheat prices during the period of the agreement.

quantities may be transferred among members whenever such action is acceptable to the countries concerned. Provision is also made for increases in purchases in times of critical need. Quantities guaranteed in the agreement include flour, which is counted in terms of its wheat equivalent. (The 1949 agreement, by way of comparison, provided for an initial amount of 456 million bushels per crop year, but this amount was later raised to 581 million bushels as some members agreed to increase their guaranteed sales and purchases.)

Second, the agreement provides for a maximum price of $2.05 per bushel and a minimum price of $1.55 per bushel for all wheat sold or purchased under its terms. Prices are quoted in terms of Canadian currency at a fixed parity with the United States dollar, and quality is set in terms of No. 1 Manitoba Northern wheat in bulk in store at Fort William/Port Arthur. (The 1949 agreement, by way of comparison, provided for a maximum price of $1.80 per bushel and for a minimum price ranging from $1.50 per bushel in the first year downward to $1.20 per bushel in the final year.)

Third, the exporting countries agree to attempt to maintain sufficient stocks of wheat to assure supplies to importing countries, and the importing countries agree to take precautions to prevent unusually heavy purchases of wheat at the beginning and closing of crop years. These provisions are specifically intended to minimize seasonal price fluctuations in the world wheat market.

Fourth, members who experience difficulty in securing their guaranteed sales or purchases may seek the assistance of the specially created International Wheat Council, comprised of representatives from all participating countries, in obtaining the quantities guaranteed under terms of the agreement. All transactions over and above the quantities specified remain unaffected.

Fifth, in the event an exporting country experiences a crop shortage, or in the event an importing country experiences a deficit in its balance of payments or a shortage of monetary reserves, the country concerned may have its obligations under the agreement suspended or altered for the period of the emergency.

Sixth, administration of the agreement rests in the hands of the International Wheat Council. Participating countries are allotted votes in proportion to their share of the total quantity of wheat covered by the agreement.

Two major criticisms may be made of the International Wheat Agreement. First, it may be alleged that the proportion of total exports and imports of wheat covered by the guaranteed sales and purchases is too

small to assure positive stabilization of the international wheat market. For example, the quantity of 595 million bushels per crop year specified by the 1953 agreement represents but two-thirds of the average annual world exports (and imports) of some 900 million bushels during the period 1945-53. Excluding the proposed guaranteed purchases of the United Kingdom, which failed to ratify the revised agreement, the 1953 agreement covers only about one-half the quantity annually entering the international market during the post-World War II period. In defense of the International Wheat Agreement, it may be argued that complete coverage is not needed in order to promote relative stability in the international wheat market. Rather, control over a substantial portion of internationally traded wheat is sufficient under ordinary circumstances to achieve a high degree of market stability. Certainly substantial coverage is more conducive to market stability than is a situation in which complete reliance is placed upon the forces of a free market.

Second, adherence to the International Wheat Agreement is costly to the United States Treasury. Since domestic prices are pressured upward under the agricultural price-support program, and are stabilized above the level established by the International Wheat Agreement, the United States is compelled to subsidize the exports of wheat required under terms of the agreement. According to testimony presented before the Senate, the cost of bridging the gap between the domestic price of wheat and the maximum price obtainable under terms of the International Wheat Agreement of 1949 totaled some $570 million during the four years of its operation, representing an average export subsidy of about 62¢ per bushel. Further testimony, based on information supplied by the Department of Agriculture, placed the probable export subsidy under the revised agreement of 1953 at about 40¢ per bushel during the crop year 1953-54.[5] To the extent, however, that exports of wheat from the United States under terms of the agreement are in excess of those normally occurring, the export subsidy is not an additional cost to the Treasury; rather, it represents a payment made in lieu of an investment in "non-disposable" accumulations of domestic stocks by the government under its price-support program.

ATTITUDE TOWARD INTERNATIONAL COMMODITY AGREEMENTS

Historically, the United States Government was long opposed to international commodity agreements on grounds that participation by government in such arrangements constituted an obstacle to the effective opera-

[5] *Agreement Revising and Renewing the International Wheat Agreement of 1949*, 83rd Congress, 1st session, Senate Document 26119, July 8, 1953, p. 6.

tion of free-market forces. During World War II, however, official thinking on the subject underwent a sharp change, in part because governmental intervention in market affairs in other connections began to be regarded as routine and "normal." Gradually the notion gained popularity that international commodity agreements covering primary commodities might be desirable in peacetime, provided (*a*) both producer and consumer interests were represented, (*b*) full publicity was given such agreements, (*c*) there existed or threatened to develop surpluses (or unemployment) not likely to be corrected in the short run through the operation of free-market forces, and (*d*) the objective of the agreements was directed toward the expansion of consumption or the shifting of productive effort to other lines. As matters evolved, the United States Government during and after World War II assumed a position of leadership in promoting international commodity agreements. Aside from its participation in such important arrangements as the International Wheat Agreement, three distinct developments during the postwar period provide evidence of this country's interest in international commodity arrangements.

First, the United States (Executive Branch) was the major force behind the drafting of the Charter of the proposed International Trade Organization, previously cited. In a section of the Charter devoted to international commodity agreements, it was conceded that the "special conditions" surrounding the production and marketing of agricultural or mineral products might warrant the adoption of international controls. Participation in international commodity agreements was held permissible (*a*) if a burdensome surplus of a primary commodity threatens in agriculture, or (*b*) if widespread unemployment or under-employment persists or threatens to arise in consequence of chronic maladjustments within the industry, e.g., as in mining.[6] Any agreements negotiated were to conform to certain prescribed standards: (*a*) Participation in agreements was to be open to any producer country desiring representation, and an equal voice was to be given consumer countries in decisions on substantive matters.[7] (*b*) The agreements were to propose methods for the correction of existing maladjustments.[8] The latter provision was in keeping with the idea that international commodity agreements should only provide temporary relief during the period in which long-run disequilibrium between supply and demand is corrected through more basic means, either through an increase in consumption or through a shift in productive effort.

[6] Art. 62 a, b.
[7] Art. 63 b.
[8] Art. 63 a, c.

Second, during most of the postwar period the United States Government actively participated in six intergovernmental commodity groups (or committees) concerned with wheat, sugar, rubber, tin, cotton, and wool. Except for wheat, however, the commodity groups had no functions other than to undertake research and to render advice to participating governments (hence they were known as "Study Groups").[9] A common service rendered by such a study group was to call attention to problems confronting or likely to confront the particular commodity group, paving the way for an intergovernmental meeting at which corrective action might be discussed. A study group, accordingly, was weak in the sense that it could only recommend but could never initiate action.

Third, following the outbreak of the Korean conflict, the relative shortages of particular raw materials needed by countries in connection with their defense programs induced the United States, along with Great Britain and France, to initiate an International Materials Conference (IMC). The IMC, which came into formal existence early in 1951, consisted of seven commodity committees (paper-paper pulp, sulphur, cotton-cotton linters, wool, copper-zinc-lead, manganese-nickel-cobalt, and tungsten-molybdenum), and included twenty-eight countries in its representation, accounting for some 80 to 90 per cent of the non-Communist world's production and consumption of the commodities concerned. The basic purpose of the IMC was to provide machinery which might allow members to meet in order (*a*) to review the supply of and demand for selected commodities, (*b*) to determine the measures needed to increase the production and to promote the conservation of selected commodities, and (*c*) to attempt to reach agreement on the international allocation of the available supplies of selected commodities. The IMC was given no powers of compulsion; member governments remained free to accept or reject any recommendations offered. Opposition to the IMC soon developed, however, especially in the United States. A common criticism took the form that the IMC was the "brain child" of the Executive Branch, and that United States participation had never been approved by Congress. Under the barrage of criticism, plans for dealing with long-run problems of supply and demand were rather quickly abandoned. With the easing of raw-material shortages during 1953, the short-run justification for the IMC also appeared to diminish. Beginning in that year, therefore, the IMC began to contract its operations with a view toward termination.[10]

[9] G. Patterson and J. N. Behrman, *Survey of United States International Finance, 1950* (Princeton: Princeton University Press, 1951), pp. 222-232.

[10] G. Patterson and J. M. Gunn, Jr., *Survey of United States International Finance, 1952* (Princeton: Princeton University Press, 1953), pp. 222-226.

APPRAISAL OF INTERNATIONAL COMMODITY AGREEMENTS

International commodity agreements are criticized most frequently on grounds that they restrict production and trade, and are therefore harmful to consumers. The avowed purpose of the agreements invariably is to regulate output and sales in order merely to *stabilize* price, but in practice they may be used to restrict output and sales in order to *raise* price. In the latter case, the agreements serve as instruments by means of which organized producer groups exploit consumers. It is not surprising, therefore, to find that leading importing countries on occasion seek to obtain a voice in the formulation of the agreements; in fact, exporting countries frequently are anxious to cooperate with importing countries because agreements arrived at jointly invite fewer retaliatory measures and tend to prove more durable. The interests of importing countries are not always fully recognized, however, even though they are consulted. The importing countries frequently import only a part of the total domestic consumption of the particular commodity, and hence they may not feel the need to exert their full force in the negotiation process. Moreover, consumer groups within importing countries are usually not as well organized or recognized as are producer groups within exporting countries.

Not only is it possible for consumers to be injured by the restrictions which international commodity agreements frequently place upon output or sales, but in the long run producer countries may also be harmed by these practices. A marked restriction of the output or sales of a basic commodity, especially if the latter absorbs a large part of a country's productive effort, ordinarily leads either to widespread unemployment or to increased output (and a surplus) of other commodities. Such possible consequences appear all the more unfortunate when it is realized there are other, and presumably better, methods of handling the particular situation. In preference to the practice of restricting output or sales to fit a given market, attention may be directed to an expansion of the market so that existing output may be profitably absorbed. One proposal along the latter lines holds that the pursuit of domestic full-employment policies by various countries, combined perhaps with programs of economic development designed to create additional employment opportunities, may serve to underwrite or increase the level of income, thereby tending to assure adequate markets for prevailing output.

Even if it is agreed that long-run adjustment through expansion is to be preferred to adjustment through contraction, an unresolved problem of short-run nature nevertheless remains. Specifically, what may particular

countries do in an immediate sense if they find themselves with surplus capacity for the production of primary commodities? Since governments are prone to act unilaterally if given no other choice, the best alternative to uncoordinated national plans may be the negotiation of international commodity agreements. If such agreements, as short-run measures, are to register even moderate success, however, it is important that they do not sanction uneconomic practices which serve to delay long-run adjustments. Rather, emphasis may more appropriately be placed upon the correction of the underlying maladjustments which gave rise to commodity surpluses in the first instance. First, the agreements need to recognize the desirability of a *shift in production* from high-cost areas either to low-cost areas or into other lines of endeavor where surpluses do not prevail. Second, the agreements need to recognize that an *increase in total consumption* is preferable to a "sharing of the market." In short, if international commodity agreements are to render a valuable and lasting service, it is necessary that they incorporate features which serve (*a*) to promote more economic production, and (*b*) to promote trade, not restrict it.

COMMODITY AGREEMENTS AND CARTELS COMPARED

International commodity agreements are similar to international cartels in that both attempt to control production and prices. Careful examination, however, reveals basic differences. International cartels include relatively few producers, and are usually private agreements. International commodity agreements, on the other hand, arise in fields where production is carried on by relatively many producers, who normally are able to reach agreement only through government intervention. There is, however, some overlapping. For example, there are instances in which commodity agreements began as private organizations (cartels) but ended up under government sponsorship; similarly, there are instances in which cartels have been sponsored by governments.

The most clear-cut and meaningful distinction between the two types of organization rests upon the use made of monopoly control. International cartels tend to exercise greater exploitative power and are tempered less by consumer interests than are international commodity agreements. For example, consumers may be given formal recognition in international commodity agreements, but such is not the case in international cartel agreements.

SUMMARY

International commodity agreements are intergovernmental arrangements concerning the production and trade of certain basic primary products. Such agreements arise because freely competitive world trade in primary products is subject to a considerable amount of instability, a situation deemed undesirable by producers, and sometimes by consumers as well.

The avowed purpose of the agreements is to regulate the production and sale of primary products so as to stabilize price. The most common criticism made of the agreements, however, is that they readily become devices for restricting output and raising price, thereby aiding particular producers at the expense of consumers.

If the agreements are to be defended on economic grounds, they need to conform to certain standards. First, the consumer interest warrants recognition. Second, in coping with surpluses, it is important that attention be directed to the elimination of excess capacity. Provision for shifting production from high-cost areas to low-cost areas or into other lines of activity is to be desired. Third, it is important that consideration be given such measures, e.g., policies of full employment and economic development, as may serve to increase income and consumption.

SELECTED REFERENCES

°Davis, J. S., *International Commodity Agreements: Hope, Illusion, or Menace*. New York: The Committee on International Economic Policy, 1947.

°Mason, E. S., *Controlling World Trade*. New York: McGraw-Hill Book Company, Inc., 1946, Part III.

°United Nations Food and Agriculture Organization, *Report on World Commodity Problems,* New York, 1949.

Zimmerman, E. W., *World Resources and Industries*. New York: Harper & Brothers, 1951

Part IV

Trade, Investment, and Currency Problems

In previous sections we learned that international trade yields economic benefits, but that countries are prone nevertheless to interfere with the free flow of trade. The decisions of countries to interfere with the operation of free-market forces are, of course, based on reasons which they believe to constitute "just and sufficient" cause. The pertinent point is that countries do not operate in a "perfect" environment. They are confronted with many problems, and they have no choice but to grapple with some of them. Part IV accordingly treats some of the major trade, investment, and currency problems which are of importance in the present-day world, and relates what has been done, or is being done, about them.

14

Commercial Policies of the United States

As THE LEADING economic power in the world today, what foreign commercial policies[1] should the United States pursue? This chapter summarizes the major commercial policies followed by the United States during various periods in its history, and undertakes to evaluate the appropriateness of its more recent policies.

HISTORY OF AMERICAN TARIFFS

Throughout its history, the foreign commercial policies of the United States have centered largely upon tariffs. Almost from the very outset this country has employed tariffs. In 1791 Alexander Hamilton, then Secretary of the Treasury, submitted to Congress his famous *Report on Manufactures* in which he outlined the case for a protective tariff in this country. In his presentation he stressed the need for mild protection as a means to develop the country's infant industries, the growth of which he felt would ensure a greater home market for agricultural production, assure a greater degree of military self-sufficiency, and in general promote national unity.

The Hamilton report provided the theoretical basis for early American

[1] The term "commercial policy" is used here to denote all those measures which relate *directly* to the importation and exportation of goods and services, e.g., tariffs and quotas. The term, so used, excludes reference to broader monetary and fiscal policies.

tariff legislation. Popular enthusiasm for protection, however, was not great during this early period when the economy was still overwhelmingly agricultural. There continued to be greater interest in cheap imports of manufactures than in the possibilities of national economic diversification. It was not until well into the nineteenth century, after considerable industry had already taken root, that pro-tariff sentiment became widespread. The protectionist sentiment arose largely in the North, which was rapidly undergoing an industrial revolution and which tended to identify protection with self-interest, while the South, still almost entirely agricultural and not inclined to identify protection with self-interest, continued to show a bias toward free trade.

Gradually the tariff question entered national politics. The Civil War, and the events of the reconstruction period, tended especially to crystallize the issues, and to put them on a partisan basis, which alignment has to a considerable extent endured to this day. The Republican party of the North has traditionally been pro-tariff, while the Democratic party, strongest in the South, has leaned toward free trade, but with some reservations in view of support sought among industrial workers in northern cities. A study of United States history reveals that tariffs have tended to rise in Republican periods, while in Democratic periods they have usually been lowered.

Congress passed four major pieces of tariff legislation during the present century. The Underwood law of 1913, enacted following the return of the Democrats to national office, put into effect the most sweeping rate reductions in half a century. It is difficult to evaluate the impact of these reductions, since World War I blurred the picture, and tended in itself to provide protection for domestic producers. Following the war, renewed foreign competition led to passage of the Fordney-McCumber law of 1922. This legislation provided for higher rates, especially on agricultural commodities. Despite this action, American agriculture remained in a relatively depressed state throughout the generally prosperous twenties. Ostensibly to help agriculture, but providing added protection for other sectors of the economy also, the Hawley-Smoot law was adopted in 1930, establishing the highest tariff duties in American history. The apparent inadequacy of tariff protection as a means to soften the impact of the Great Depression paved the way for a general tariff reform by the Democrats upon their return to national office in 1933. New legislation followed in the form of the Trade Agreements Act.[2]

[2] For an excellent treatment of the history of the tariff in the United States, see A. Isaacs, *International Trade, Tariff and Commercial Policies* (Chicago: Richard D. Irwin, Inc., 1948), Part II.

THE RECIPROCAL TRADE AGREEMENTS PROGRAM

The Trade Agreements Act, Section 1 of which is an amendment to the Tariff Act of 1930, was adopted in June, 1934. The act had as its avowed purpose the liberalization of this country's tariff structure. Among its major features were the following. First, tariff reductions by this country were made dependent upon equivalent concessions by foreign countries; hence the program of tariff liberalization came to be known as the *Reciprocal* Trade Agreements Program. Second, trade agreements negotiated under the act were to incorporate the principle of "unconditional most-favored-nation treatment." Third, the President was given wide discretionary power in the negotiation of trade agreements.

Most-Favored-Nation Treatment

Most-favored-nation (MFN) treatment refers to the manner in which the tariff concessions extended by Country A to imports from Country B are (or may be) extended to imports from Country C or other third countries.

MFN treatment may take either of two forms, conditional or unconditional. Under *conditional* MFN treatment, Country A agrees to reduce its duty upon specific imports from Country B, provided B also agrees to reduce its duty upon particular imports originating in A, but such tariff reductions are extended to third countries only as the result of additional bargaining and only in exchange for equivalent concessions. Under *unconditional* MFN treatment, on the other hand, concessions granted by Country A to Country B are automatically extended to all third countries, whether or not equivalent concessions are made in return. Unlike the conditional form which sets up a "most-favored" country, the unconditional form, in automatically extending concessions to all countries, "favors" all countries on an *equal* basis.

The Trade Agreements Act provided for the negotiation of trade agreements embodying the MFN clause in its unconditional form.[3] This means that any concession which the United States grants another country under a trade agreement negotiated pursuant to the Trade Agreements Act is automatically and unconditionally extended to all other countries,[4] whether

[3] The United States long practiced MFN treatment in its conditional form, but in 1922 adopted the unconditional form.

[4] There are some exceptions. First, Cuba and the Philippine Republic are accorded special preferential treatment in all trade agreements negotiated by the United States. Second, the President is authorized to withhold trade concessions from those countries which discriminate against United States commerce or which pursue policies likely to counteract the purposes of the Trade Agreements Act.

or not the latter countries make equivalent concessions in return. In turn, any concession (with some specified exceptions) granted a third country by a country with whom the United States has negotiated a trade agreement is automatically and unconditionally extended to the United States. Though the trade agreements negotiated under the Trade Agreements Act are bilateral agreements, inclusion of an unconditional MFN clause in the agreements serves to make concessions granted under them applicable to additional countries (i.e., the concessions are "multilateralized").

Negotiation of Tariff Reductions

The Trade Agreements Act authorized the President to enter negotiations and conclude agreements with foreign countries in order to lower tariff barriers, here and abroad. Agreements concluded in this manner were to take effect upon proclamation by the President without review by Congress. In essence, Congress established broad limits within which the President, with the help of interested government agencies, might act to conclude reciprocal trade agreements at such times and on such terms as day-to-day developments might permit, thereby greatly simplifying the whole procedure of effecting tariff reductions.

Action by the President, however, was made subject to specific limitations. First, the President's power to lower (or raise) duties was limited to 50 per cent of the rates in effect in June, 1934. (This provision, as we shall see, was modified in 1945.) Second, the President was expressly forbidden to transfer items from the dutiable list to the free list, or vice versa. Third, before concluding an agreement, the President was required to give public notice in order that interested parties might have an opportunity to express their views on the proposed changes. Finally, the President was to confer with and to work through the Tariff Commission and other interested departments, e.g., the Departments of Agriculture, Commerce, State, and others, in order to promote policies not likely to operate at cross-purposes with other governmental policies in effect or in process of development.

The "Chief-Supplier" Principle

In negotiating trade agreements, the usual procedure followed by the United States is to grant direct concessions only to so-called "chief suppliers," i.e., to those countries who are, or are likely to become, the principal source (or a major source) of supply of the commodity in question. This procedure holds an advantage for the United States in that it rules out the possibility of concessions made to "minor" suppliers accruing to the benefit of "major" suppliers (through unconditional MFN treat-

ment) without the latter having to grant a *quid-pro-quo.* By withholding a concession until it can be offered directly to the "major" supplier in exchange for an equivalent concession, the United States is able to use its bargaining power to maximum advantage in securing easier access to foreign markets for its own exports.

Extension of Trade Agreements Legislation

The Trade Agreements Act was initially adopted for a three-year period, and was renewed several times thereafter, generally for either two- or three-year periods. Substantial tariff reductions occurred during the thirties, largely as a result of the vigorous support given the program by Cordell Hull, then Secretary of State. Pro-tariff sentiment fell to a low point during the prosperous years of World War II, and periodic renewal of the legislation evoked little controversy. Since the duty on many articles had been reduced by the full 50 per cent permitted in the original law, provision was made in 1945 to allow the President to negotiate further reductions of rates up to 50 per cent of those prevailing on January 1, 1945.

The trend toward freer trade was not seriously brought into question until 1947. In February of that year the President, acting in response to the demands of Congress that the Administration provide more adequate facilities for the "relief" of domestic firms confronted by competitive imports, issued an executive order requiring all trade agreements negotiated in the future to contain an "escape clause."[5] Inclusion of an escape clause in an agreement reserved to the United States the right to withdraw or modify a tariff concession, provided the latter caused or threatened "serious injury" to competitive domestic producers. In 1948, the combination of growing competition from abroad and a mild recession at home served to bring forth a considerable display of protectionist sentiment. In consequence, the Trade Agreements Act, up for renewal, was extended for only one year, and a special "peril-point" provision was adopted. The latter provided that it was to be the duty of the Tariff Commission to determine the minimum tariff rate which might be adopted "without causing or threatening serious injury to the domestic industry producing like or similar articles" to those under consideration for trade-agreement concessions.

The Trade Agreements Extension Act of 1949 extended for three years, retroactive to June, 1948, the President's authority to negotiate trade agreements. While the peril-point provision was eliminated from the 1949 legislation, the requirement that each new trade agreement contain an

[5] The use of the "escape clause" in the United States dates from December, 1942, when such a provision was included in a trade agreement concluded with Mexico.

escape clause continued in effect. The two-year extension approved in 1951 again incorporated the peril-point provision, and wrote the escape-clause provision into the law as well. Also, a provision was included specifically providing that benefits accruing from concessions were not to be made available to the so-called "iron-curtain" countries.

The Reciprocal Trade Agreements Program ran into pronounced opposition when up for renewal in 1953, following the return of the Republicans to national office. After a stiff Congressional fight, the program was extended for one year through approval of the Trade Agreements Extension Act of 1953. Under its terms, a seventeen-man Commission on Foreign Economic Policy was appointed to investigate and evaluate current United States foreign economic policy, and to make recommendations to Congress concerning future policy. The report of the commission (the so-called "Randall Report"[6]) included a recommendation that tariffs be further lowered on a selective basis. The recession conditions of 1954, paralleled by growing protectionist sentiment, served to prevent this recommendation from being translated into action. The Trade Agreements Extension Act of 1954, providing for a one-year extension, contained one new feature. It was provided that no action was to be taken to decrease the duty on any article if the President held that such reduction would threaten domestic production needed for projected national defense requirements.

"GATT"

During and immediately after World War II the foreign commercial policy of the United States was directed, in general terms, toward the attainment of two major objectives: (1) international agreement upon a code governing conduct in commercial matters, and (2) international agreement designed to reduce or eliminate specific trade barriers. Painstaking efforts were made to lay the groundwork for concrete action along these lines. Finally, in 1947, at the instigation of the United States, an international conference was held in Geneva for the purpose of formulating specific proposals. The accomplishments of this conference were two-fold: (1) draft of a Charter for a proposed International Trade Organization (ITO), and (2) agreement on reduction of tariff and trade barriers (through adoption of the General Agreement on Tariffs and Trade—GATT).

The Charter of the proposed ITO set forth a code governing the conduct of member countries in commercial matters, and contained provisions for a formal structure to handle enforcement. In addition to commercial

[6] Commission on Foreign Economic Policy, *Report to the President and the Congress*, Washington, January, 1954.

policy (tariffs, quotas, subsidies, internal controls, etc.), the Charter treated such matters as domestic employment, economic development, and foreign investment. At a subsequent conference, held in Havana in 1948 (the so-called "Havana Conference"), general agreement was reached by the representatives of fifty-four countries. Failure of the United States Congress to ratify the agreement reached in Havana, however, resulted in the ITO's never coming into formal operation.

In contrast, GATT, also framed at the Geneva conference, was widely accepted, twenty-three countries, including the United States, subscribing at the outset. This agreement consists of two general parts. The first section contains general provisions, including the articles which set forth rules governing trade between the contracting parties. These provisions, dealing with such matters as tariffs, quotas, subsidies, and internal controls, are similar to those of Chapter IV ("Commercial Policy") of the ITO Charter, and were accepted pending the then-anticipated adoption of the ITO. In reality, GATT put into effect a portion of the contents of the Charter of the ITO. The second section of GATT contains a schedule of concessions resulting from various negotiations.

The basic purpose of GATT was to diminish trade restrictions, especially as related to tariffs. Under GATT, representatives of participating countries meet in special conferences at periodic intervals to swap tariff and other concessions. The concessions are negotiated on a bilateral basis, and are extended to other countries by virtue of unconditional MFN treatment. The fact that numerous negotiating teams are present facilitates arrival at relatively many concessions, and turns what is normally a *bilateral* procedure into what amounts to a *multilateral* procedure.

The Geneva conference resulted in 123 separate trade agreements being signed. Of the agreements, twenty-two were signed by the United States (i.e., the United States signed an agreement with each of the other countries then participating). The concessions negotiated at this conference covered approximately 50,000 commodity items. Since the Geneva conference, two further sessions devoted to tariff negotiations have been held (at Annecy, France, in 1949, and at Torquay, England, in 1950-51). The importance of GATT may be visualized by the fact that the thirty-four countries now included[7] are responsible for approximately four-fifths of all world trade. Tariff concessions made thus far apply to products which account for more than two-thirds of the total import trade of the participating countries, and for more than one-half of the total import trade of the world.

[7] As of July 31, 1954.

Countries with which the United States had trade agreements in 1954, either on a direct bilateral basis or under terms of GATT, are shown in Fig. 8.

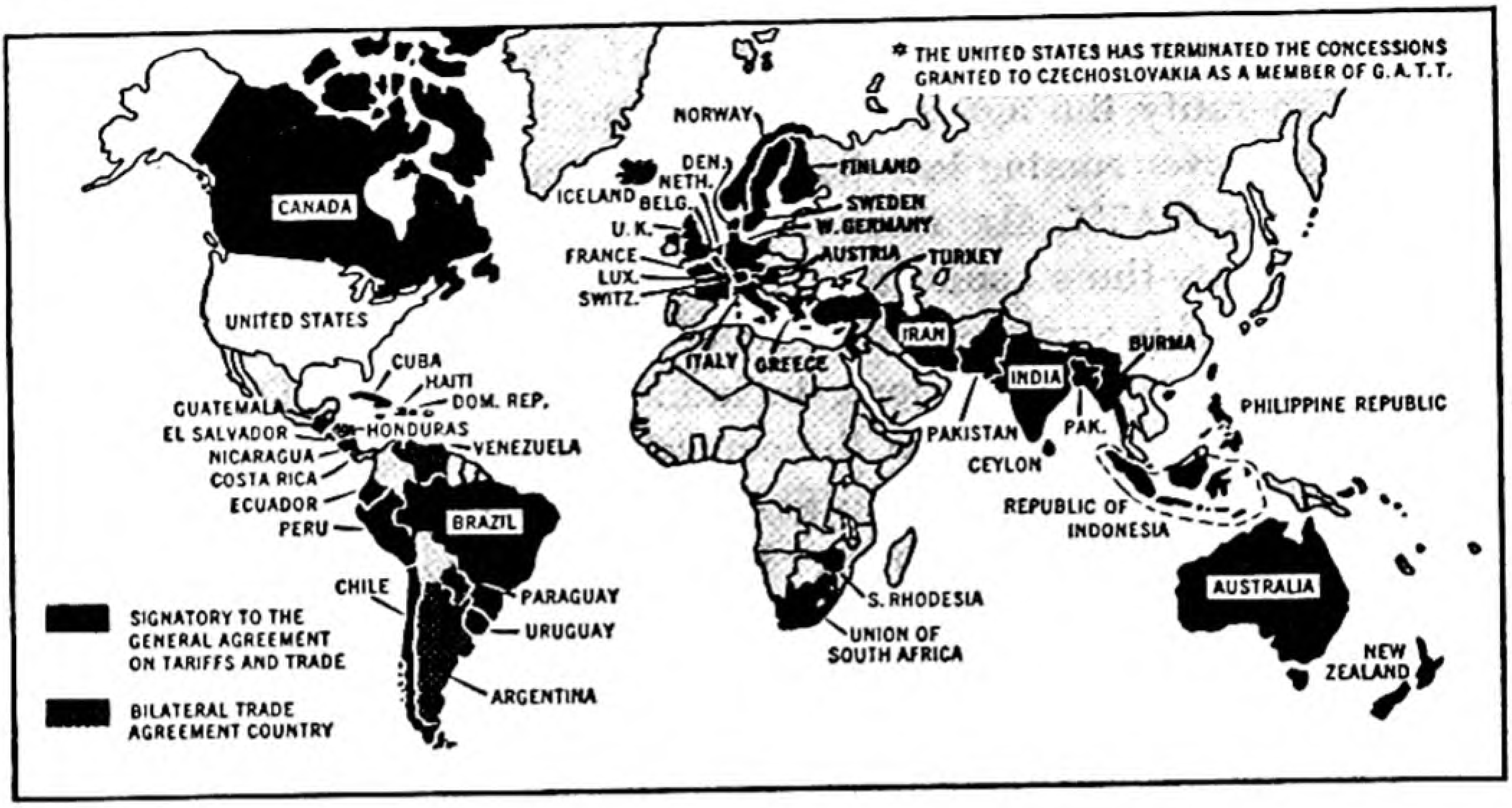


Figure 8

Countries with which the United States had Trade Agreements, August, 1954

Source: U. S. Department of Agriculture, *The Export Problem,* Washington, October, 1954, p. 36.

AN EVALUATION OF THE TRADE-AGREEMENTS PROGRAM

If we measure the success of the trade-agreements program by the extent to which duties have been lowered, our conclusion is likely to be that the program has been successful. We see (Table 20) that duties collected as a percentage of the value of dutiable imports rose from 27 per cent under the Underwood law to 38 per cent under the Fordney-McCumber law and to a high of 53 per cent under the Hawley-Smoot law. This period of rising rates was followed by a reduction to 37 per cent by 1939 under the Trade Agreements law and a very substantial further reduction to 15 per cent in 1947 (when GATT was put into effect) and 13 per cent in 1952. About one-half of this apparent decline, however, was due to a rise in prices which lowered the ad valorem incidence of the specific rates of duty. The reduction between 1933 and 1952, if measured by applying each set of rates to the volume of trade in 1949, was from 25.8 to 13.3 per cent, a reduction of 49 per cent.[8]

[8] U. S. Tariff Commission, *Operation of the Trade Agreements Program,* Fifth Report, Washington, 1953, pp. 19-20.

Reference to the increasing volume of imports within lower duty brackets yields equally impressive figures (Table 21). Of the dutiable imports for consumption during 1952, 94 per cent entered at current ad valorem rates of 30 per cent or less; only 82 per cent of the same imports would have been in this rate bracket if subject to the rates in effect in 1945, and if subject to pre-1934 rates, this rate bracket would have applied to but 75 per cent of the imports.

Table 20

Average Rates of Duty under United States Tariff Laws, 1913-1952

Tariff Law		Duties collected as percentage of value of dutiable imports
1913-21	Underwood law	27.0
1922-29	Fordney-McCumber law	38.5
1930-33	Hawley-Smoot law	52.8
1939	Trade Agreements law	37.3
1947	GATT	15.3
1952	GATT	13.3

Source: Data 1913-1947 from U. S. Tariff Commission, *Operations of the Trade Agreements Program,* Part 1, Washington, 1948, p. 19; 1952 data from U. S. Tariff Commission, *Operation of the Trade Agreements Program,* Fifth Report, Washington, 1953, p. 20.

Table 21

United States Dutiable Imports for Consumption in 1952: Proportion Subject to Rates of Duty in Effect in Select Years, by Height-of-Duty Brackets

Rate of duty (per cent ad valorem)	Percentage of distribution if subject to rates in effect:		
	Before any trade agreements signed	On Jan. 1, 1945	On Jan. 1, 1953
10.0 or less	32.2	43.8	52.3
10.1 - 20.0	19.6	23.1	30.2
20.1 - 30.0	23.2	14.9	11.5
30.1 - 40.0	10.0	8.8	4.1
40.1 - 50.0	4.1	6.0	1.0
50.1 - 60.0	5.0	1.8	.6
60.1 - 70.0	1.7	.8	.1
70.1 - 80.0	1.0	.3	.1
80.1 - 90.0	1.8	.4	.1
90.1 or more	1.4	.1	. . .

Source: U. S. Tariff Commission, *Effect of Trade Agreement Concessions on United States Tariff Levels Based on Imports in 1952,* Washington, 1953, p. 15.

While the foregoing statistics clearly indicate that the imports of the United States now enter at lower rates of duty than was the case earlier, they do not reveal the extent to which the existing rates of duty continue to exclude potential imports. Statistics expressed in terms of *overall* reductions are misleading in that they obscure the high rates which continue to apply to *particular imports* (Table 22). The latter rates, many of which exceed 50 per cent, frequently prove completely protective. Viewed from this standpoint, the success of the trade-agreements program in lowering tariffs assumes more modest proportions.

Table 22

Some United States Imports Dutiable at High Rates, 1953 (ad valorem percentages)

Brandy	60	Jute cordage	55
Brushes	50-89	Laces	50-90
China and porcelain	50-81	Optical glass	50
Clocks	60-172	Pistols and revolvers	52-139
Cotton cloth	50-60	Scientific instruments	50
Earthenware	58-65	Scissors	93-107
Fishing tackle	53-55	Sodium nitrite	58
Glassware	50	Watches	52-69
Hats	78-95	Wine	50-57
Jewelry	55	Woolen fabrics	51-66

Source: U. S. Tariff Commission, *Articles on Which the Ad Valorem Equivalent of the Present Rate of Duty is 50 Percent or Higher* (Investigation under Section 332 of the Tariff Act of 1930; issued June 10, 1954), pp. 1-34.

All factors considered, the operation of the trade-agreements program has contributed toward the substantial lowering of tariffs. This, of course, has provided grounds for criticism by so-called "protectionists," both those directly affected by specific tariff reductions and those inclined to view with disfavor any large-scale and general movement toward freer trade. Criticism, however, has also come from so-called "free traders." Of the many and varied criticisms which have been offered by those who may broadly be grouped in the latter category, four merit special attention. We may briefly examine these.

Uncertainty of the Future

The Trade Agreements Act is not a permanent part of American law, but requires periodic renewal. Its renewal in recent years, especially since 1948, has occurred only after considerable opposition has been beaten

down, and frequently only after "compromise" amendments (e.g., escape clauses and peril-point provisions) have been adopted. These facts are widely known. The effect, so it is sometimes alleged, is to weaken the whole program of trade liberalization. A common contention is that the lingering fear that the United States may some day fail to renew its trade-agreements legislation serves to deter producers and investors, both abroad and in this country, from unreservedly committing themselves to long-range plans. Without a sound basis for long-run planning, so it is argued, effective international competition becomes impossible.

The foregoing argument, as frequently presented, is in large part the outgrowth of some basic misconceptions. It is true that the present trade-agreements legislation requires periodic renewal, and it is true that there is no assurance that future renewals will always incorporate features which promote freer trade; indeed, there is no positive assurance that the trade-agreements legislation will continue to be renewed. The important fact, however, is that lapse of the trade-agreement laws would affect only *proposed* trade agreements. It would stop negotiations and would preclude any new agreements, but *existing* trade agreements would continue in effect. If producers and investors feel uncertain, such feelings may well be warranted by virtue of the "loopholes" in the existing agreements, but it seems to be stretching a point to claim that their uncertainties derive fundamentally from the likelihood, or lack of it, of additional agreements being negotiated in the future.

Escape Clauses

One of the "loopholes" in the present program is found in the escape clauses inserted in trade agreements, primarily to appease protectionist-minded persons and groups. An escape clause provides that a concession on any commodity may be withdrawn, in whole or in part, whenever, as a result of the concession or of "unforeseen" developments, importation of the commodity increases by an amount sufficiently great to cause or threaten "serious injury" to a domestic industry producing like or similar commodities. By virtue of an executive order issued by the President in February, 1947, all trade agreements concluded thereafter were required to contain escape clauses. This feature was written into the Trade Agreements Extension Act of 1951, along with a provision that escape clauses be incorporated, as soon as practicable, in all existing trade agreements as well.

A fundamental criticism made of escape clauses is that they introduce an element of uncertainly which impairs the potential effectiveness of the trade-agreements program. New investments and expanded productive

facilities, both abroad and in this country, may appear warranted on the basis of a particular concession. The fact, however, that it is possible for the concession to be revoked, in whole or in part, at any time creates a situation which induces investors and producers to act with extreme hesitancy before committing themselves to any change in plans. If foreign producers are to compete effectively in the American market, for example, they frequently must undertake relatively heavy investments at home; but such investments can hardly be expected to be forthcoming if there is no positive assurance that the producers will later even have a chance to compete in the American market. As far as investors and producers are concerned, so it is argued, a concession which is revokable is little better than no concession at all.

Actually, applications for relief under escape clauses have not been numerous to date, indicating either that tariff concessions granted have had no serious adverse repercussions upon domestic producers or that escape clauses have not in themselves constituted a serious loophole in the trade-agreements program. By late 1954, the Tariff Commission had received only slightly more than fifty applications for relief. In most instances the Tariff Commission found no grounds for action, and in several instances the President failed to carry out the recommendations of the Tariff Commission for withdrawal of concessions. Only in four instances, involving relatively unimportant commodities, have concessions actually been revoked. Despite the limited use of escape clauses to date, there is always a danger that intensified competition in the future may bring forth a wave of requests for the withdrawal of concessions. More important, perhaps, is the fact that a loophole, however insignificant it appears on the surface, may have a bad psychological effect abroad, thereby deterring trade liberalization in these quarters.

The Peril Points

Peril-point provisions, contained in the Trade Agreements Extension Acts of 1948 and 1951, are frequently cited as further evidence of less-than-wholehearted enthusiasm in the United States for tariff reform. According to these provisions, the President was not to conclude a trade agreement until the Tariff Commission had ascertained and reported the maximum concession it believed could be made on each commodity subject to negotiation without causing or threatening "serious injury" to competitive domestic producers. Strictly speaking, the President was not rigidly bound by the decisions of the Tariff Commission. If he negotiated an agreement containing concessions in excess of those reported by the Tariff Commission, however, he was required to report such action, along with reasons

for doing so, to Congress within thirty days of the effective date of the agreement.

The difference between an escape clause and a peril-point provision basically is as follows: an escape clause authorizes a concession to be withdrawn *after* it is found to cause or threaten "serious injury," but a peril-point provision of the type indicated seeks to *prevent* such a concession from ever being granted in the first place.

The Balance-of-Payments Problem

The foregoing criticisms stress the weakening of the trade-agreements program which has occurred through the adoption of "escape-type" amendments. Serious as these criticisms are, they are overshadowed by another criticism which, if valid, leaves little to be said for the program which purports to be the keystone of American commercial policy today. This criticism centers about the allegation that the *objective* and *approach* of the trade-agreements program are out of step with the needs of the times. Let us examine this proposition.

During the thirties, when the trade-agreements program was introduced and developed, the United States, and much of the rest of the world, suffered from an acute depression. The world needed an all-around expansion of trade. The reduction of tariffs on a reciprocal basis was a step in the right direction if promotion of trade was the objective.

In contrast, during the decade following World War II, trade suffered not from the contractive effects of a depression, but from persistent imbalances in international accounts. Specifically, the United States consistently showed a balance-of-payments surplus, while the rest of the world, aggregatively considered, showed a deficit vis-à-vis the United States. There are those who argue that what is needed (among other things) under these circumstances is a mutual expansion of trade consistent with economic growth *plus* a particular expansion of imports on the part of the United States in order to assist in the correction of the fundamental imbalance in the international accounts of this country vis-à-vis the rest of the world. If the imbalance is to be dealt with through tariff policy, what is needed is a program of unilateral (not reciprocal) tariff reductions on the part of the United States. This notion has been responsible, in part, for the popularity in the United States of the slogan, "*Trade, not Aid.*"[9]

In short, according to the foregoing criticism, the Reciprocal Trade Agreements Program was an appropriate policy for the depression era of

[9] This slogan originated in Great Britain, and was adopted in the United States by Republican party officials in the campaign of 1952.

the thirties, but it is ill-conceived for the purpose of coping with international maladjustments of the type which have figured prominently during the decade following World War II.

Generalizing further, the Reciprocal Trade Agreements Program is based on the assumption that *all* countries gain by lowering their tariffs, since such reductions serve to promote a greater volume of trade. Or, to put it differently, the appropriate tariff policy for the United States is also the appropriate tariff policy for all other countries. It is this notion which some critics hold open to question. These critics point out that not all countries are "in the same boat." Conditions vary widely, and the appropriate policy for one country may not be the appropriate policy for some other country. For example, there may be a strong case for selective protection in an underdeveloped country, but no such case may exist in an "advanced" country. If all this is true, the appropriate tariff policy for the United States, whatever it may be, is not one which handles tariff reductions on a *quid-pro-quo* basis.

OTHER ASPECTS OF UNITED STATES COMMERCIAL POLICY

In addition to protective tariffs, the United States today employs other types of controls to restrict its imports. A few of these bear brief mention.

Import Quotas

The United States employs quotas, both of the tariff-quota type and of the embargo type, the latter being used either to entirely exclude particular commodities or to limit their importation to specified amounts. The quotas in effect most commonly apply to agricultural commodities. For example, under Section 22 of the Agricultural Adjustment Act, as amended, most types of cotton imports (since 1939) and wheat and wheat flour imports (since 1941) are subject to quota restrictions. Import quotas are ordinarily imposed in addition to tariff restrictions. For example, wheat imports are subject to a duty of 42¢ per bushel (since 1924), and are, in addition, restricted by quota provisions.

The use of quotas to restrict the importation of specific agricultural products arose largely as a means to prevent the domestic agricultural price-support program from being undermined. Under the price-support program, the price of a "supported" commodity (e.g., cotton, wheat, etc.) is raised to and maintained at a level well above the free-market level, and ordinarily well above the competitive world level. Whenever the domestic price of a commodity is raised above the world price by an amount in excess of applicable duties (plus transport costs, and other costs involved

in entering the United States market), imports of the commodity are likely to occur. Thus, a commodity from abroad, lower-priced but produced in a country having no price-support program, may enter the United States market where it sells at the high price brought about by the intervention of the United States Government and the outlay of public funds. The United States, in reality, ends up supporting world prices, not merely domestic prices; or the domestic price is pulled down to, or toward, the world price. What is more, since there almost always is a domestic surplus of the particular commodity granted price support, the United States is placed in the position of importing a commodity when it already has an exportable surplus. Clearly, if the domestic price of a commodity is to be maintained above the world level for any considerable period of time, and if domestic surpluses are not to be added to through importation, the domestic market must be insulated against competitive imports. An import quota performs this function.

The use of import quotas by the United States, however, is open to two major criticisms. First, the use of import quotas is incompatible with the policy of trade liberalization which the country professes to follow. Second, import quotas, like protective tariffs, tend to lead to a less economic allocation of productive effort.

"Buy American" Legislation

The purpose of "Buy American" legislation is to compel the United States Government to give preference to domestic commodities in making purchases. For example, an amendment to the Treasury and Post Office Department Appropriation Act in 1933, continued in succeeding years in substantially unchanged form, provided as follows:

> . . . only such unmanufactured articles, materials, and supplies as have been mined or produced in the United States, and only such manufactured articles, materials, and supplies as have been manufactured in the United States substantially all from articles, materials, or supplies mined, produced, or manufactured . . . in the United States, shall be acquired for public use.

Exceptions are made when the cost of the domestic commodity is considered unreasonable, or when purchases in the home market are deemed not in the public interest. In interpreting "reasonableness of cost," the Procurement Division of the Treasury Department established a differential of 100 per cent on purchases under $100 and a differential of 25 per cent on purchases of $100 or over. These differentials are in addition to the tariff on foreign purchases.

In defense of "Buy American" legislation, it is to be noted that foreign producers do not pay taxes in the United States. It is commonly argued that the Government should discount the attractiveness of lower foreign prices, since the practice of making purchases outside the country leads to a loss of tax revenue on an equivalent volume of production which might have occurred domestically. This argument, of course, is not strictly accurate, since it fails to grasp the connection between the volume of imports and the volume of exports. By way of criticism, it is argued that "Buy American" legislation increases the cost of government purchases (even if allowance is made for all direct and indirect revenue considerations), and that the legislation provides a special form of protection to particular producers (i.e., to those supplying goods to the Government).

"Ship in American Bottoms" Legislation

Another "Buy American" practice relates to the preferential treatment which the Government accords American shipping facilities. For example, according to a law enacted in 1934, goods acquired with funds lent by any government agency were required to be transported in United States flag commercial vessels whenever such facilities were available. In interpreting this provision, the Government permitted a sharing of cargoes, with a minimum of 50 per cent, where possible, reserved for American cargo carriers. More recent legislation reiterated this provision. For example, the legislation which authorized both the European Recovery Program (Marshall Plan aid) and the Mutual Security Agency (military and economic assistance) contained provisions requiring at least 50 per cent of the gross tonnage of equipment, materials, or commodities sent abroad in connection with the programs to be carried in American-flag vessels. (In addition, the Government grants subsidies to American shipbuilders and operators, intended to help put them on a competitive basis.)

An argument in favor of preferential treatment for American shippers exists in the need to maintain a core of shipping capacity for reasons of national defense. An argument against such treatment is that in operation it is tantamount to a tariff on foreign shipping services.

Customs Procedure

Labeling requirements, marks of origin, procedures for valuation, and other complicating customs requirements comprise an "invisible tariff" which may serve to exclude imports. The United States undertook, in the Customs Simplification Act of 1953, to simplify the administrative and procedural provisions of its customs laws, and to eliminate certain provisions held detrimental to trade. Specific changes included the following:

(1) simplification of accounting, auditing, and investigating requirements, (2) exemption of certain commodities from marking requirements, and (3) reduction of penalties for undervaluation of imports. However, one of the more important reforms proposed — clarification of the method of valuation of imports — was deleted from the legislation prior to passage.

COMMERCIAL POLICY FOR THE UNITED STATES

What foreign commercial policy *should* the United States pursue? Most economists are prone to argue that this country should practice *relatively* free trade. They generally arrive at this conclusion on the basis of either or both of two major lines of reasoning. First, the present-day world-trade situation calls for freer trade on the part of the United States. Second, the United States, as the world's leading economic power, stands to gain from freer trade. Let us examine these propositions.

United States Policy and World Trade

During the post-World War II period, the United States showed a surplus in its balance of payments, while the rest of the world, aggregatively considered, showed a deficit. Specifically, during the eight-year period, 1946-53, the rest of the world showed a deficit of approximately $32 billion in its transactions with the United States (Table 23, item 13). The deficit averaged about $4 billion per year; during 1946-49 the deficit averaged about $7 billion per year, and during 1950-53 the average was slightly in excess of $1 billion per year. As shown in Table 23 (item 14), *economic aid and loans* from the United States constituted the basic means of financing the world's "dollar deficit." Economic aid and loans totaled $32.5 billion; in addition, military aid (Table 23, item 4) totaled $9.8 billion.

Basically, there are two ways open to the United States to remove deficits of the foregoing type (and, hence, to remove the need of financing them). First, the United States can limit its foreign sales to whatever amount foreigners are able to pay for. This procedure serves to remove the need for foreign aid, but it does so by reducing United States exports. (The essential point is that the surplus of exports over imports is roughly matched by foreign aid. The elimination of one serves to largely eliminate the other.) Second, the United States can increase its imports (and/or its new foreign investments) as a substitute for foreign aid. In short, if the United States is to hold its export volume at a relatively high level free of the prop of large-scale foreign aid, it must either increase its imports, or increase its new foreign investments, or do both.

If the approach chosen is that of allowing a greater flow of imports, lower tariffs appear appropriate. The question may be raised, however, as to whether even the removal of *all* tariffs would serve to increase imports sufficiently to eliminate the need for foreign aid of the magnitude

Table 23

Balance of Payments of the United States, 1946-1953 [1]
(billions of dollars)

Balance-of-payments items	1946	1947	1948
1. Exports of goods	11.7	16.0	13.3
2. Exports of services	3.0	3.8	3.7
3. Exports of goods and services (1 + 2)	14.7	19.8	17.0
4. Deduct: Grants of military supplies and services	. . .	— .1	— .4
5. Total "commercial" exports of goods and services (3 + 4)	14.7	19.7	16.6
6. Imports of goods	—5.2	—6.1	—7.8
7. Imports of services	—1.8	—2.2	—2.4
8. Private gifts (net)	— .7	— .7	— .7
9. Total imports of goods and services (6 + 7 + 8)	—7.7	—9.0	—10.9
10. Balance on goods and services (5 + 9)	7.0	10.7	5.7
11. Exports of private U.S. capital (net)[3]	— .4	—1.0	— .9
12. Imports of foreign capital and identified items (net)[4]	.2	. . .	.3
13. Deficit of rest of the world with U.S. (10 + 11 + 12)	6.8	9.7	5.1
Financed by:			
14. U. S. Government economic aid and loans [5]	—5.0	—5.7	—4.6
15. Net transfers of gold and dollars [6]	—1.8	—4.0	— .5
16. Financing of "dollar deficit" of rest of the world	—6.8	—9.7	—5.1

[1] Minus signs indicate debits.
[2] Partly estimated.
[3] Includes long-term and short-term U. S. private capital.
[4] Includes net movements of foreign long-term capital, net dollar disbursements of IBRD and IMF, and some statistical adjustments.

cited. The answer appears to be that the task can't be handled by tariff removal alone. Deficits averaged about $4 billion per year during 1946-53, and United States merchandise imports averaged about $8.8 billion per year. Thus, United States imports during these years would have had to have been some 50 per cent above prevailing levels in order to remove the need for foreign aid (assuming the prevailing export volume). It is most unlikely that the United States tariff structure represented a barrier of such proportions during these years. In fact, one authority has calculated that if the United States eliminated all tariffs and quotas (under con-

ditions prevailing in 1951), the annual increase in imports would amount to only between $1.2 and $2.6 billion.[10]

Our conclusion, therefore, is that the complete removal by the United States of its tariffs cannot, in and of itself, serve to promote trade by an amount sufficiently great to eliminate deficits of the magnitude experienced by the aggregate of the rest of the world vis-à-vis the United States during the years 1946-53. (In the period after 1950, the absence of United States tariffs *might* have facilitated imports sufficiently great to allow

1949	1950	1951	1952	1953 [2]	Total 1946-53
12.3	10.7	15.5	15.8	16.4	111.7
3.7	3.7	4.7	4.8	4.9	32.3
16.0	14.4	20.2	20.6	21.3	144.0
— .2	— .6	—1.5	—2.6	—4.4	—9.8
15.8	13.8	18.7	18.0	16.9	134.2
—7.1	—9.3	—11.7	—11.5	—11.7	—70.4
—2.5	—2.8	—3.4	—4.3	—4.8	—24.2
— .5	— .5	— .4	— .4	— .5	—4.4
—10.1	—12.6	—15.5	—16.2	—17.0	—99.0
5.7	1.2	3.2	1.8	— .1	35.2
— .6	—1.3	—1.1	—1.1	— .4	—6.8
.8	.4	1.1	.7	.2	3.7
5.9	.3	3.2	1.4	— .3	32.1
—5.8	—3.7	—3.2	—2.5	—2.0	—32.5
— .1	3.4	. . .	1.1	2.3	.4
—5.9	— .3	—3.2	—1.4	.3	—32.1

[5] Excludes U. S. Government military aid (item 4) and U. S. subscription to IBRD and IMF. Economic aid constitutes by far the greater portion of item 14.

[6] Excludes net transfers of gold and dollars to and from international institutions.

Source: Based on *Staff Papers*, Commission on Foreign Economic Policy, Washington, February, 1954, Annex I, p. 15.

the recorded deficits to be offset. It should be noted, however, that if exchange controls had not been employed by the various deficit countries during these years to divert their purchases away from the United States, the magnitude of the deficits would likely have been far greater.) In any event, the fact remains that further action by the United States in lowering its tariffs can *help* to promote a high volume of trade on a "paying basis." Reliance must, of course, be placed on other policies also (e.g., foreign in-

[10] H. S. Piquet, *Aid, Trade, and the Tariff* (New York: Thomas Y. Crowell Company, 1953), p. 23.

vestment and foreign economic development, discussed in subsequent chapters).

Policy for the Leading Country

The productive capacity and efficiency of the United States is today the envy of the world. Under the circumstances, what trade policy is appropriate for this country? Most economists are inclined to offer a standard answer: the leading country tends to profit most under a system of relatively free trade.[11] In moving toward freer trade, the United States does not need to fear competition in those fields of production in which her producers hold a comparative advantage; rather, what the United States does need to fear in not moving to freer trade is that those of her producers who do hold a comparative advantage suffer a loss of potential markets abroad. Anything which serves to expand foreign markets tends also to benefit those domestic producers having a comparative advantage. One way to expand foreign markets is to increase the importation of those commodities in which foreign producers hold a comparative advantage. To stand in the way of such an international division of labor is to retain a domestic market in preference to gaining a new foreign market, and to rule out more efficient production in order to preserve less efficient production. Special-interest groups, of course, are prone to resist the adjustments needed to promote freer trade and a more economic allocation of productive effort, but the pressures of economic necessity tend in time to modify even the most inflexible of situations.

In writing about the foregoing situation, one author describes the position of the United States in the following colorful language:

> The plain fact is that the United States today needs free trade, as Great Britain needed it in the nineteenth century. It would be fatal, of course, for any American politician to advocate free trade; but economic necessities have a way of mastering the shibboleths of politics. . . . Economically the United States needs free trade, and in the name of the "American system" of protection, if necessary, she is going to get it.[12]

Most economists, however, would probably not go this far. Rather, they would be inclined to favor "freer" trade, as distinct from "free" trade. The very fact that national-security issues enter the picture prevents absolute free trade from being a practical goal in the world of today. Between

[11] It is interesting to note that in the period when Great Britain was the commercial leader of the world, she was a staunch supporter of free trade. Once her relative position began to worsen, however, she moved rapidly toward moderate protection.

[12] D. B. Marsh, *World Trade and Investment* (New York: Harcourt, Brace and Company, 1951), pp. 487-8.

the present situation and that of free trade, however, lies a vast area within which many things are possible.

SUMMARY

Throughout its history, the foreign commercial policies of the United States have centered largely upon tariffs. For over a century the general trend was toward higher tariffs, culminating in the Hawley-Smoot law of 1930. Since 1934, when the Reciprocal Trade Agreements Program was introduced, tariffs have been gradually lowered. The latter program involved (1) the negotiation of tariff reductions on a *quid-pro-quo* basis, and (2) the extension of such tariff concessions to third countries under terms of unconditional most-favored-nation clauses inserted in all trade agreements negotiated.

Between 1933 and 1952, the average rates of duty of the United States (measured by applying each set of rates to the volume of trade in 1949) were reduced by 49 per cent.

Despite its effect in lowering tariff barriers, the Reciprocal Trade Agreements Program has been criticized on various scores (even by so-called "free traders"). For example, (1) the effectiveness of the program has been "watered down" through adoption of "compromise" amendments (e.g., escape clauses and peril-point provisions), and (2) the program was better suited to the world economic conditions of the thirties than to those of the forties and fifties.

SELECTED REFERENCES

Brown, W. A., Jr., *The United States and the Restoration of World Trade.* Washington: Brookings Institution, 1950.

Harris, S. E. (ed.), *Foreign Economic Policy for the United States.* Cambridge: Harvard University Press, 1948.

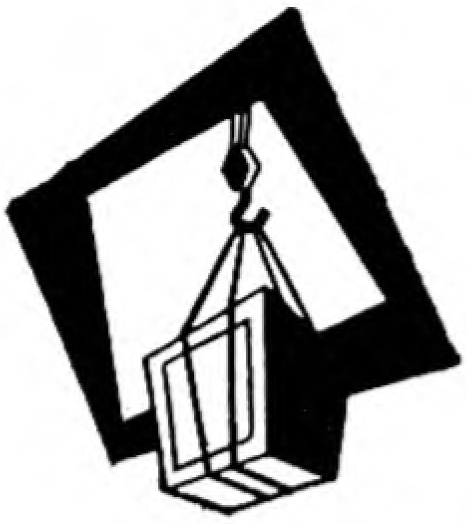
°Mikesell, R. F., *United States Economic Policy and International Relations.* New York: McGraw-Hill Book Company, Inc., 1952.

°Patterson, G., and others, *Survey of United States International Finance, 1953.* Princeton: Princeton University Press, 1954. (Issued annually since 1950.)

°Piquet, H. S., *Aid, Trade, and the Tariff.* New York: Thomas Y. Crowell Company, 1953, Chaps. 1-8.

U. S. Tariff Commission, *The Tariff and its History,* Washington, 1934.

°———, *Operation of the Trade Agreements Program,* Washington. (Issued periodically.)



15

International Investment

INTERNATIONAL INVESTMENT is an important matter for the United States and other countries. First, the United States with its relatively abundant supplies of capital stands in sharp contrast to much of the rest of the world, large sections of which are confronted with a distinct shortage of capital. Unless access is had to adequate capital, economic development and a higher standard of living become dim prospects in a distant future for much of the world. Second, the United States has a stake in world prosperity as well as in its own domestic prosperity. The level and scope of prosperity are related to the volume and area of investment.

This chapter presents a survey of various aspects of international investment, and the following four chapters treat the closely related question of economic development.

DEBTOR-CREDITOR AND BORROWER-LENDER RELATIONSHIPS

The events of World War I changed the United States from a debtor country to a creditor, while the events of World War II changed Great Britain from a creditor to a debtor.[1] From the foregoing one may conclude

[1] One British writer describes the post-World War II position of Great Britain as follows: "On capital account, therefore, the United Kingdom (notwithstanding its creditor position on investment income account) appears to be a net debtor." See A. R. Conan, *The Sterling Area* (London: Macmillan & Co., Ltd., 1952), p. 142.

that countries pass through stages in their financial evolution, and such is indeed the case.

In identifying the stages through which countries pass, it is important to distinguish the *current* movement of new investments to and from a country (i.e., a country's *borrower-lender* relationship with the rest of the world during, say, a single year) from the *cumulative* financial position of a country (i.e., a country's *debtor-creditor* status relative to the rest of the world as determined by the aggregate of its investment transactions over a period of years). A creditor country is one whose long-term and short-term foreign investments exceed its long-term and short-term foreign liabilities, while a debtor's foreign liabilities exceed its foreign investments. Lending in excess of borrowing, if continued long enough and in sufficient volume, serves to turn a debtor into a creditor, while borrowing in excess of lending serves eventually to turn a creditor into a debtor. Repayment of obligations incurred in the past may turn a debtor into a creditor; the change of status occurs when foreign liabilities no longer exceed foreign investments. Similarly, receipt by a country of such repayments may turn it from a creditor to a debtor; debtor status is acquired when the foreign investments held no longer exceed foreign liabilities.

From the standpoint of its international financial position, a country may thus be classed as a debtor or a creditor; more fully, it may be a debtor-borrower, a debtor-lender, a creditor-lender, or a creditor-borrower.

TYPES OF FOREIGN INVESTMENTS

Foreign investments may be classified in a number of ways, several of which bear mention.

1. "Portfolio" or "Direct." Portfolio investments are loans of money. The investor acquires foreign securities, government or private; if private, he ordinarily holds only a small part of the stock issue, and therefore is able to wield little or no control over the enterprise. In the case of a direct investment, on the other hand, the investor not only provides capital, but also obtains control of the enterprise or participates in its management. Included in the latter category are foreign-owned and foreign-managed factories, mines, plantations, and other similar enterprises. Thus, an American who acquires a coffee plantation in Brazil makes a direct investment, while a Brazilian who purchases the common stock of General Motors Corporation is said to have made a portfolio investment.

Most borrowing countries are inclined to favor portfolio investments over direct investments. Both give rise to an influx of capital, which

generally is regarded with favor, but the foreign "control" which frequently accompanies direct investments tends to be of lesser importance in the case of portfolio investments. Of course, some portfolio investments have the drawback of utilizing fixed-interest securities; the borrowing country is then obliged to meet fixed debt-service payments, in depression as well as in prosperity. Lending countries, in contrast, frequently prefer direct investments over portfolio investments. Direct investments carry with them the rights of management, whereas portfolio investments do not. Also, there is always a possibility that direct investments may yield greater returns per dollar volume of investment, especially during periods of prosperity.

2. **"Productive" or "Unproductive."** Viewed from a domestic standpoint, a productive investment is said to be one which leads to an increase in productive capacity, thereby giving rise to the means to service and eventually repay the debt, i.e., the investment is self-liquidating, entirely or partly. In contrast, an unproductive investment is one which does not give rise to income, thereby requiring funds for debt service and repayment to be derived elsewhere in the economy. For example, a loan to construct a factory may be productive, but a loan to construct a palace is almost certain to be unproductive.

The same test is sometimes applied to foreign investments. If a foreign investment gives rise to income, it is productive; if it does not, it is unproductive. Some economists, however, feel that when investments are international in character, the essential test of necessity differs from the foregoing. The servicing and repayment of debt owed abroad requires access to foreign exchange. For this reason, a foreign investment is frequently held to be productive only when it gives rise to foreign exchange, directly or indirectly. Even though a foreign investment gives rise to output (goods or services) and income, it may nevertheless be deemed unproductive in an international sense if it does not, directly or indirectly, give rise to foreign exchange. The essential test thus is the presence or absence of "*foreign-exchange* productivity." The "catch" in applying this test is that it is difficult to find a foreign investment which does not at least remotely affect the supply of foreign exchange. Even a public stadium (or a museum, or a monument), for example, can prove productive in this sense if it attracts tourists. Fortunately, it is possible to distinguish investments which are relatively productive of foreign exchange from those which are relatively unproductive of foreign exchange. A factory which produces goods for export, for example, is unquestionably more productive of foreign exchange than is a monument which few care

to view. In this relative sense, therefore, foreign-exchange productivity may provide a test of the degree of productiveness or unproductiveness of a foreign investment.

3. **"Long-term" or "Short-term."** The Department of Commerce defines a long-term investment as a claim or liability with a "stated original maturity of one year from the date of issuance," and a short-term investment as a claim or liability with a "maturity of one year or less."[2] Long-term investments include most types of government bonds, corporate securities, and direct investments. Short-term investments include bank balances, brokerage balances, holdings of certain currencies, government securities with short maturities, and various types of commercial paper.

The financing of trade in particular commodities, e.g., capital-goods items, has given rise to "medium-term" credit. Credit of this type typically has a duration of one to five years. The duration is longer than what passes as short-term, but the type of transaction financed is more closely akin to the short-term category than to the long-term category. The Export-Import Bank in the United States and the Export Credits Guarantee Department of the Board of Trade in Great Britain handle credit (i.e., make investments) of this type.

4. **Terms of Repayment: "Internal" and "External" Debts.** Foreign investments may be classified according to the currencies in terms of which they are expressed, e.g., an obligation may be in terms of the currency of the lending country, of the borrowing country, or of some third country. Those debts payable in terms of the borrower's currency are said to be internal, while those payable in the lender's currency, or some third currency, are said to be external. For example, United States Government bonds held abroad constitute an internal debt for this country, since repurchase is in terms of dollars. In contrast, the intergovernmental loan of $3.750 billion granted by the United States to Great Britain following World War II constitutes an external debt for the latter country, since repayment is scheduled to occur in dollars, not sterling.

5. **Private or Government.** Foreign investments are undertaken by either private persons and firms or by governments. Private funds are made available through purchases abroad of private or government securities, or through the acquisition abroad of direct investments. Government loans are generally made to other governments, and only in rare instances do governments lend to private foreign enterprises. The post-World War

[2] U. S. Department of Commerce, *Balance of Payments of the United States, 1949-1951*, Washington, 1952, p. 93.

II loan of the United States to Great Britain, previously cited, is an example of an intergovernmental loan, while the British Government's investment in the Anglo-Iranian Oil Company is an example of government investment in a private enterprise located abroad.

The basic factors which motivate foreign investment are not the same in the case of governments as in the case of private investors. In evaluating a prospective investment opportunity, a major point of consideration for a private investor is anticipated yield. A government, on the other hand, generally attaches little significance to the direct yield of its foreign investments (i.e., loans). Rather, a government's concern tends to center upon the *indirect* benefits generated by foreign lending. For example, a government may lend in the hope of improving international relations. Or, a government may lend in order to create a physical environment conducive to subsequent investments by private investors. As an illustration, one country may lend to another country in the hope of "setting off" additional developments in the latter which then create foreign-investment opportunities for its own private investors.

THE INTERNATIONAL INVESTMENT POSITION OF THE UNITED STATES

Prior to World War I, the United States was a debtor country. In financing its early economic development, this country was dependent in part upon foreign capital, secured chiefly from Great Britain, which had industrialized earlier. Up to 1874 the country experienced an unfavorable balance of trade, the surplus of imports being financed through use of foreign credit. Thereafter, with the exception of two years, exports exceeded imports as this country met interest and dividend payments, undertook repayment, and began to lend on its own. Foreign lending by this country, however, remained relatively unimportant until after 1900, by which time sufficient development had occurred in the domestic economy to support some exports of capital, moving chiefly to neighboring countries such as Canada, Mexico, and the Caribbean countries. By 1914, this country's foreign investments had risen to $3.5 billion, but the country nevertheless remained a net debtor by a margin of $3.7 billion.

The events of World War I changed the United States from a net debtor to a net creditor. The change of status resulted from the combination of (*a*) this country's reduction of its foreign indebtedness and (*b*) its own foreign lending. During the war, on the one hand, some American securities held abroad were sold in the United States to obtain dollars for the purchase of supplies in this country. On the other hand, the United States lent heavily to the Allied Governments, on a private basis

prior to this country's entry into the war, and directly by the Government once this country became an active belligerent. At the termination of hostilities, the United States was a net creditor by a margin of over $3 billion, exclusive of amounts lent by the Government during the war (and largely repudiated in later years).

The amount by which the United States remained a net creditor diminished during the interwar period. Foreign lending, which continued heavy during the prosperous twenties, all but ceased with the onset of the Great Depression. In addition, foreign debtors defaulted in wholesale fashion during the depression, leading to a general write-off of many obligations. In 1939, when World War II began, United States foreign investments amounted to $11.4 billion, while foreign assets in the United States totaled $9.6 billion, leaving this country a net creditor by a margin of only $1.8 billion.

During World War II, little private foreign investment occurred, but the United States Government financed loans and grants in unprecedented

Table 24

International Investment Position of the United States, Selected Years (billions of dollars)

	1914	1919	1930	1939	1946	1953
United States Investments Abroad:	3.5	7.0	17.2	11.4	18.7	39.5
Private	3.5	7.0	17.2	11.4	13.5	23.7
Long-term	3.5	6.5	15.2	10.8	12.3	22.1
Direct	2.6	3.9	8.0	7.0	7.2	16.2
Portfolio	.9	2.6	7.2	3.8	5.1	5.9
Short-term	. . .	.5	2.0	.6	1.3	1.6
Government [1]	. . .	. . .	. . .	. . .	5.2	15.7
Foreign Investments in the United States:	7.2	4.0	8.4	9.6	15.9	23.6
Long-term	6.7	3.2	5.7	6.3	7.0	9.1
Direct	1.3	.9	1.4	2.0	2.5	3.7
Portfolio	5.4	2.3	4.3	4.3	4.5	5.4
Short-term assets [2]	.5	.8	2.7	3.3	8.9	14.5
United States Net Creditor Position	—3.7	3.0	8.8	1.8	2.8	15.8
Net long-term	—3.2	3.3	9.5	4.5	10.5	28.7
Net short-term	— .5	— .3	— .7	—2.7	—7.6	—12.9

[1] Excludes World War I loans; includes some short-term assets.
[2] Includes U. S. Government obligations in 1946 and 1953.

Source: U. S. Department of Commerce, *Survey of Current Business,* Washington, May, 1954, Table 1, p. 10.

volume. Following the war, the Government continued to extend loans and grants in large volume; in addition, private foreign investments by Americans rose to a level far above that of the thirties.

United States private foreign investments of all kinds totaled \$23.7 billion in 1953 (Table 24); adding the claims of the United States Government, this country's foreign investments totaled \$39.5 billion. On the other hand, foreign investments in the United States totaled \$23.6 billion. On the total of private and government account, the United States was thus a net creditor in 1953 by a margin of \$15.8 billion.

The private United States investments which occurred after World War II were mainly direct investments, involving ownership and control,

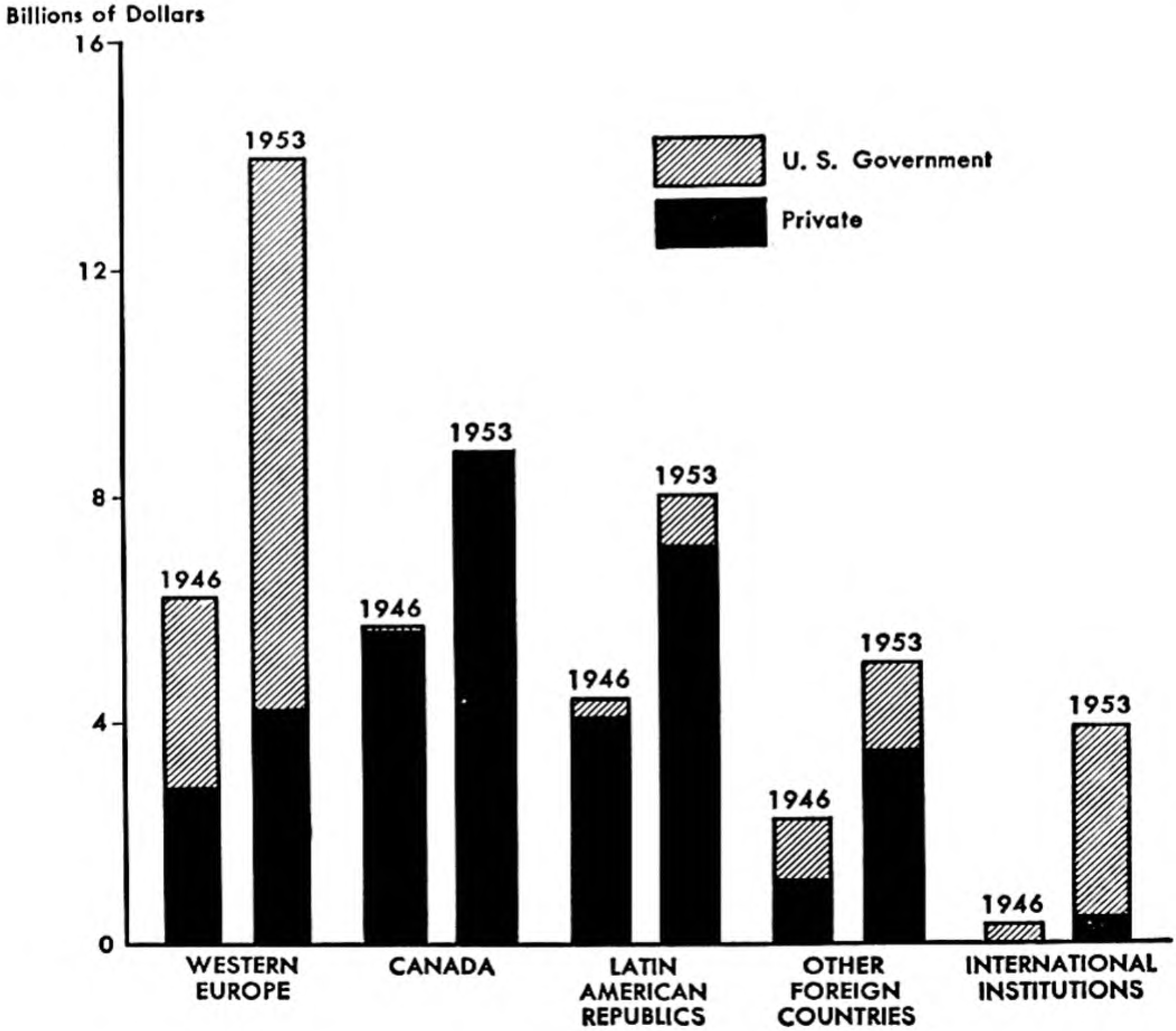


Figure 9

United States Foreign Investments by Areas, 1946 and 1953

Source: U. S. Department of Commerce, *Survey of Current Business,* Washington, May, 1954, p. 10. Amounts shown refer to investment position at close of year.

rather than portfolio investments. For example, the outflow of private investment funds during the period 1946-53 averaged $1.5 billion per year, of which an average of $1.3 billion per year was direct investment. The private investments have been largest in Canada, Latin America, and the Middle East, and are heavily concentrated in the petroleum industry. The geographic distribution of United States investments in 1946 and in 1953 is shown in Fig. 9.

THE ECONOMICS OF FOREIGN INVESTMENT

We may briefly examine the economic processes involved in lending and in repaying debt.

The "Export of Capital"

What is meant by an "export of capital"? An export of capital rarely involves a physical transfer of currency, for the currency of one country does not ordinarily circulate freely in another country. Nor does an export of capital necessarily involve the immediate exportation of goods, services, or gold in the same value as the loan. Rather, an export of capital occurs via two separate and distinct steps: (1) a transfer of "purchasing power," and (2) an export (at some time) of goods, services, or gold.

When an international loan is made (whether by, or to, a government or private persons), the lending country in reality places a segment of its purchasing power at the disposal of the borrowing country for use within the lending country. Currency does not cross a frontier in the process; rather, the foreign borrower simply acquires a claim upon the currency, and hence the purchasing power, of the lending country. This *surrender of purchasing power* by the lender enables the borrower to purchase goods, services, or gold within the lending country. In return, the lender acquires securities or other property rights within the borrowing country.

The borrower may immediately utilize the proceeds of the loan in their entirety for the purchase of goods or services within the lending country. More often, however, the borrower spends only part of the proceeds at the outset. The remainder may be kept abroad, typically in the form of a bank balance. The borrower is then able to draw upon the bank balance from time to time in order to purchase additional goods or services within the lending country. When the borrower is a government, such bank resources held abroad may from time to time be placed at the disposal of either authorized government agencies or private residents (i.e., the government may sell foreign exchange to residents, payable in domestic currency). It is interesting to note, in the latter instance, that imports

occur by virtue of a foreign loan, but the persons doing the actual importing have had no hand in the negotiation of the foreign loan.

The proceeds of a foreign loan may also be used for the purchase of gold which, when transferred to the borrowing country, serves as a basis for monetary expansion in the latter country. While little used, this method nevertheless is of some interest in showing how purchasing power is transferred internationally. Very briefly, the mechanics and results are as follows. The transfer of gold to the borrowing country serves to increase the money supply of the latter. As this occurs, the demand for domestic goods tends to increase, as does also the price of domestic goods relative to import goods. The increase in domestic demand and the relative increase in domestic price lead to a decrease in exports and to an increase in imports. In consequence, manpower and resources normally used for the production of export goods are instead diverted to the production of goods and services for domestic use; in addition, imports of goods and services occur in excess of those normally possible.

We thus see that the end result in each instance is the same: *an international loan is transferred in the form of goods and services.* The transfer may be immediate, or it may occur over a period of time. Only if the proceeds of a loan are kept idle is there an absence of such a transfer.

The manner in which capital is transferred when a direct foreign investment is undertaken is similar to what occurs when a loan leads to acquisition of portfolio investments. For example, if an American firm wishes to establish a foreign subsidiary, say, in Brazil, it typically sets aside a sum of dollars, part of which sum is used for the purchase of equipment and supplies in the United States for shipment to Brazil. Funds, however, are also needed in Brazil for the purchase of a site, for the purchase of supplies obtainable locally, and for the payment of labor until such time as the new establishment comes into receipts of its own. Local currency is needed in the latter instances, so that the problem becomes one of obtaining cruzeiros for dollars. The transfer of purchasing power is accomplished when the American firm acquires a deposit in a Brazilian bank in terms of cruzeiros, while dollars (or dollar-claims) so obtained by the bank come to be reckoned as part of Brazil's dollar-exchange reserves, providing a basis for the sale of dollars to other persons who hold cruzeiros but who desire to make foreign payments in dollars. From an overall economic standpoint, therefore, the export of capital in consequence of a direct foreign investment, just as in the case of a new portfolio investment, occurs through a movement of goods and services.

"Tied" Loans

Foreign-loan agreements which carry a provision that the proceeds may be spent only in the lending country are known as "tied loans." Loans of the United States Export-Import Bank, for example, are tied, but those of the International Bank for Reconstruction and Development are not.

The usual purpose of a tying clause in a loan contract is to assure the lending country that the proceeds will be spent with it. Such a stipulation is unnecessary, however, since the lending country is assured of additional exports by virtue of the loan, even though the proceeds are utilized via third countries. Irrespective of the number of countries through which the proceeds pass, they always return to the country of origin, unless held entirely idle. The tying feature thus does not assure a country of extra export business, but it does tend to assure a foreign market for *particular* domestic businesses, rather than to allow the business to fall upon the economy in uncertain and random fashion.

The difference between tied and non-tied loans may be tangibly illustrated. If the Export-Import Bank, for example, makes a tied loan for the construction of a hotel in a Latin-American country, the recipient is eligible to spend the loan proceeds only in connection with the specific project and only within the United States. Utilization of the loan proceeds leads to the exportation from the United States of, say, structural steel, cement, and other equipment and supplies. A few American industries producing the required commodities are positively assured of an export market. By way of contrast, let us assume that the identical loan is not tied. The borrower then is free to spend the proceeds either in the United States or in any other country, depending upon where the required imports are obtainable most advantageously. Assuming the expenditures to be in Great Britain, British concerns thereby come into possession of dollars which, if used, return to the United States in payment of exports to Great Britain. Significantly, however, the exports of the United States, when made to Great Britain, may be foodstuffs, not the equipment and supplies needed for the construction of a hotel in Latin America. In short, a tying clause in a loan contract tends to narrow down the range of possibilities as to who in the domestic economy is to be the direct beneficiary of the added exports which follow utilization of the loan proceeds.

Tied loans are open to one very basic criticism. Since loan proceeds are then eligible for use only in the lending country, borrowers are prevented from "shopping" in other countries where purchases may perhaps be made more advantageously. This obstruction to multilateral trade tends

to result in a less efficient utilization of the world's productive effort than otherwise possible.

The Process of Loan Repayment

Any discussion of international lending must necessarily concern itself with the question of repayment. Basically, there are two methods by which foreign loans may be repaid: (1) through refunding, or (2) through a transfer of goods (including gold) and services.

Refunding refers to new borrowing by a debtor in order to obtain capital for the immediate or rapid repayment of an outstanding obligation. Refunding constitutes a method by which a particular debt may be discharged, but in the process the debtor simply exchanges one creditor for another. The discharge of one foreign loan with the proceeds obtained from another, and equal, foreign loan in no way affects the total volume of debt.

Repayment, on the other hand, involves the final discharge, rather than shifting, of an outstanding obligation. In order for a country to absolutely reduce its net foreign indebtedness, short of outright default, it must earn foreign exchange, which it can do only if its total receipts from foreign sales of goods, services, and gold exceed its total payments for an aggregate of like imports. Stated in other terms, a country's total foreign liabilities, relative to its total foreign assets, may decrease, barring default, only if there has been, or is, an export surplus on current account (including gold) in its balance of payments.[3] In short, *the final discharge of international indebtedness requires a net transfer of goods and services, similar to, but in the opposite direction from, the transfer which follows the incurrence of indebtedness.*

The transfer of interest and dividends occurs along similar lines. When interest and dividend payments on foreign liabilities exceed like receipts from foreign assets, the balance of payments registers net receipts upon the aggregate of all other transactions (i.e., net receipts on the basis of the aggregate of exports of goods, services other than the returns upon capital, and gold, and on the basis of new capital imports) in sufficient amount to offset the net debit balance on investment income. Conversely, the balance of payments of a country having a net credit balance on investment income shows equivalent net payments (a net debit balance)

[3] In practice, a country may also discharge foreign liabilities through the use of proceeds obtained from the sale abroad of its foreign assets. While this practice may serve to lower the absolute volume of foreign indebtedness, it can do so only up to the point that foreign assets prove sufficient. It offers no solution for a debtor country once its foreign assets have all been sold.

on its transactions covering the aggregate of goods, services other than the returns upon capital, gold, and new investments. Thus, a creditor country in whose balance of payments the current inflow and outflow of new investments are exactly equal must be willing to accept its net earnings on investment account in the form of net imports (as measured by the aggregate of goods, services other than the returns upon capital, and gold). If a creditor country, however, is unwilling to accept such net imports, aggregatively considered, it may instead balance its international accounts through the alternative of accepting additional new foreign investments.

The implication of the foregoing analysis for the real world is that a creditor country must accept an import surplus (i.e., a net importation as measured by the aggregate of goods, services other than the returns upon capital, and gold), or it must undertake a larger volume of foreign investment. Failure to do either, or both, necessitates a balancing of accounts through the medium of grants. One certain conclusion which follows is that a restrictive trade policy is inappropriate for a creditor country, since it seriously impairs the entry of goods and services by means of which earnings and amortization payments are transferred.

THE CASE FOR FOREIGN INVESTMENT

Foreign investment is generally pictured as being beneficial to the economies of both the lending and borrowing countries. We may briefly summarize some of the alleged economic benefits which accrue. (Admittedly, other benefits, not purely economic in nature, also accrue. The treatment below, however, is limited to those benefits which are economic, in a narrow sense.) Brief mention is also made of major disadvantages.

Economic Benefits to the Lending Country

The economy of a lending country tends to receive two major types of benefit from foreign investment.

1. **Increased Supplies.** Foreign investment may assist in the development of sources of supply of commodities needed in the lending country. Thus, foreign investments undertaken by the United States have facilitated development in foreign countries of capacity for the production of foodstuffs not readily produced in this country (e.g., bananas). Similarly, other foreign investments of the United States have promoted production abroad of raw materials vital to the industries of this country (e.g., petroleum, nickel, and copper).

2. **Increased Exports.** Foreign investment may promote a market for some of the output of the lending country. From a short-run standpoint, the act of lending gives rise to a foreign claim upon purchasing power in the lending country, the exercise of which claim results in additional exports from the lending country. Moreover, the expansion in exports is able to occur without a like volume of imports having to occur; not until, and unless, repayment occurs are there offsetting imports. The fact that lending and exportation are intimately related gives a clue as to why a country interested in a high level of domestic income and in full employment may choose, at least on occasion, to engage in foreign lending.

From a long-run standpoint, the receipt of capital may lead to improvements which increase productivity and income in the borrowing country. The achievement of a higher level of income in the borrowing country may, in turn, promote a greater volume of export trade for the lending country, year after year. The fact, also, that improvements in the borrowing country may promote a more economic utilization of resources and manpower provides a gain not only for it, but for the lending country and for other countries as well.

Disadvantages to Lending Country

The major disadvantage of foreign investment to the lending country is that subsequent repayment may not be forthcoming, or may be difficult to accept. The history of international investment is replete with cases where direct investments have been lost, in whole or in part, through expropriation or other means, and where portfolio investments have been lost through default.

In cases where payment is made, the end effect upon the creditor country is an added volume of imports. Such imports frequently tend to be viewed with misgiving, especially by those domestic producers for whom they constitute a source of competition.

Economic Benefits to the Borrowing Country

When a borrowing country receives foreign capital, it is able on that account to purchase abroad more than otherwise possible. Such purchases, not currently paralleled by sales, may prove of benefit to the economy of a borrowing country, especially when the latter wishes to (*a*) offset a deficit in its balance of payments, (*b*) speed economic development, or (*c*) finance a war.

1. **Offset Temporary Balance-of-Payments Deficits.** A country may be assisted over a temporary balance-of-payments deficit by means of foreign capital made available to it. The receipt of foreign capital allows a coun-

try to finance imports of an equivalent value. If the amount of capital received is sufficient to offset the deficit, the country may then continue to import at the existing level even though its international earnings are insufficient to sustain this volume of importation. In short, by means of the stopgap use of foreign capital a country may be able to tide itself over those difficulties which give rise to a deficit in its balance of payments without its having to alter fundamentally its international purchasing habits. A case in point is Great Britain following World War II; receipt of loans (and grants) from the United States enabled Great Britain to offset, in part, the "dollar gap" in her balance of payments.

2. **Speed Economic Development.** Access to foreign capital may allow a country to promote economic development at a more rapid pace, and with less sacrifice in domestic consumption standards, than otherwise possible. Why this is so may readily be seen by contrasting the two basic methods of financing economic development: (1) reliance upon domestic resources, and (2) reliance upon foreign borrowing. In contrasting the two methods, we may cite actual cases.

The industrialization of the Soviet Union since the 1917 revolution constitutes a classic example of economic development of the first type. Largely agricultural and only one step removed from feudalism at the time of the revolution, the Soviet Union embarked upon a program of speedy economic development, relying almost exclusively in its efforts upon the utilization of domestic resources. Under the planned economy which was instituted, the level of consumption, already relatively low, was further curtailed in consequence of the diversion of a large segment of total productive effort to the creation of facilities for added production in the future (as distinct from the production of commodities for use in the present). In reality, consumption was curtailed in order to allow a "surplus" (capital) to be squeezed from existing production; this surplus was then "ploughed back" (invested) into the economy, providing a basis for greater production thereafter. This government-directed capital accumulation was designed to promote a rapid build-up of the country's productive capacity, thereby giving promise of a higher level of consumption in the future (provided, of course, that potential benefits are not later channeled into other uses). The example of the Soviet Union demonstrates that the decision of a country to "pull itself up by its own bootstraps," so to speak, entails a deliberate sacrifice in living standards, possibly for a considerable period of time. This sacrifice may be relatively great, especially if the initial standard of living is low and the pace at which economic development is undertaken is rapid.

A second method of promoting economic development involves use of foreign capital. The United States, for example, relied upon foreign capital to some extent during its early history. In order to promote economic development at a pace more rapid than possible on the basis of its own resources, and without a drastic impairment of domestic living standards, the United States chose to supplement its own accumulation of capital with foreign capital, obtained largely from Great Britain, which had industrialized earlier. Use of the foreign capital allowed the United States to undertake importation in excess of the volume otherwise possible. In short, instead of relying exclusively upon its own productive capacity, the United States chose to draw also upon the productive capacity of foreign countries. Subsequently, as production and income increased, the United States was able to begin repayment and eventually to undertake foreign lending of its own. The example of the United States demonstrates that foreign capital may be used to supplement domestic capital, thereby facilitating speedy development without the need for a drastic impairment of domestic living standards.

3. **Finance a War.** Most countries, when engaged in a war, experience a reduction in their export volume (since domestic output is needed at home). At the same time, import requirements tend to increase. To the extent that international purchases exceed international sales, credit must enter the picture. Resort to foreign borrowing thus enables a country to free itself of export demands and, in addition, to acquire imports in amounts not otherwise possible. In short, foreign borrowing enables a country to supplement its own production with the production of foreign countries, thereby increasing its strength as a belligerent.

Disadvantages to Borrowing Country

While access to foreign capital may yield benefits to a country, some disadvantages are also discernible. Two major drawbacks may be noted: (1) control may accompany capital, and (2) repayment may prove difficult.

1. **Foreign Control.** When a country receives foreign capital, it may also find it necessary to accept an element of foreign control. For example, a loan agreement may place any number of requirements upon a borrowing country. Even in the absence of formal stipulations, the desire for a loan may cause a borrowing country to behave in a manner somewhat different than usual. Again, if foreign investment is direct, the ownership and operation of specific enterprises by foreigners may give the latter a "voice" in domestic matters.

2. **Repayment.** The process of debt repayment requires that the debtor country earn a surplus of foreign exchange. It is because of the difficulty involved in earning such a surplus that a foreign obligation is sometimes, deliberately or of necessity, defaulted upon.

DETERRENTS TO PRIVATE FOREIGN INVESTMENT

Under purely competitive conditions, the factors of production, barring transport costs, tend to be employed where their earning power is greatest. While the return upon capital varies widely,[4] the prevailing rate depends basically upon the scarcity or abundance of capital relative to the other factors of production. Thus, the rate tends to be relatively low in the capital-rich, "advanced" countries, e.g., in the United States, and relatively high in the underdeveloped countries, which generally are short of capital. Under the circumstances, it is only fair to ask why private capital has not during recent decades moved in larger volume from the capital-rich to the capital-poor countries. The answer lies in the fact that there are important deterrents to the movement of private capital, some of which are cited below.

1. **Unfamiliarity of Investors with Foreign Investment.** Potential investors frequently are unaware of foreign investment opportunities, or are unacquainted with the process of foreign investment itself. In an attempt to lessen this deterrent as it applies to United States private foreign investment, the Department of Commerce has offered the suggestion that the Foreign Service help business locate suitable investment outlets and, in general, that the Government undertake to provide fuller investment information.[5]

2. **The Threat of War.** A turbulent international situation, in which war is an ever-present possibility, serves to discourage large-scale foreign investment, especially in those countries likely to be subjected to direct physical damage or to foreign occupation.

3. **The Trend to Socialism.** The existence, or possible future growth, of socialism serves to deter private foreign investment. Under socialism, governments typically either subject private business to rigid control or enter business directly. Neither situation gives rise to an investment climate likely to attract a high volume of private foreign capital.

[4] Earnings on the total of all United States direct foreign investments, before foreign or United States corporate taxes, averaged 26 per cent on investment in 1950. Computed from U. S. Department of Commerce, *Foreign Investments of the United States,* Washington, 1953, Tables 1 and 19, pp. 2, 54.

[5] U. S. Department of Commerce, *Study of Factors Limiting American Private Foreign Investment,* Washington, 1953, p. 35.

In some instances, socialism leads to government monopolies in various fields of business enterprise, thereby completely excluding foreign investors from the particular fields of activity. In other instances, where competitive operation is allowed, private foreign investors are unable to compete successfully, especially since the government-operated enterprises frequently de-emphasize profit or are granted special tax treatment and preferential access to supplies and markets.

4. **The Growth of Nationalism.** In some cases, the growth of socialism is accompanied by an intensification of nationalist feeling, but in other cases nationalist feeling arises under a system in which free enterprise predominates. In either event, however, the growth of nationalism generally carries with it a mass of discriminatory legislation aimed at foreign-owned enterprises. Such laws sometimes appear to have a justification in view of some past abuses perpetrated in the name of international investment, but the passage of the legislation is frequently belated and, unfortunately, often serves to deprive the countries of much-needed foreign capital. Commonly included in the anti-foreign legislation are provisions requiring official approval prior to the undertaking of a direct investment, provisions requiring a certain percentage of the employees of an enterprise to be nationals, provisions stipulating the types of property which may be held by the enterprise, provisions limiting profits eligible for withdrawal from the country, and similar other regulations designed to apply only to foreign-owned enterprises. Even in the absence of discriminatory laws, the unfriendly attitude frequently evident in the press or in official statements may be sufficient to deter investment by foreigners.

Nationalism sometimes culminates in the outright expropriation of foreign-owned enterprises. Classic examples include the expropriation by Mexico of its railway system in 1937 and of its oil industry in 1938, the attempted expropriation by Iran of the British-owned oil industry in 1952, and the expropriation by Guatemala of certain foreign-owned banana lands in 1953. The fear that nationalization of other foreign-owned holdings may occur in the future, especially under circumstances where there is no positive assurance that reimbursement will be either immediate or adequate, serves to deter new large-scale private foreign investments.

5. **The Transfer Problem.** The prevalence of exchange control, or the possibility that exchange control may be imposed, discourages potential investors and tends to make present investors less willing to expand operations. If earnings, and principal, are "frozen" in a country, the incentive needed for private investment is dulled, if not entirely destroyed.

In this connection, Argentina employs the procedure under her exchange-control system of issuing "certificates of origin" on new investments undertaken by foreigners. These certificates provide an official record and confer upon the investor the right to later withdraw the amount invested, as well as a fixed percentage of investment annually to cover interest and dividends. In the absence of an arrangement of this or similar type, foreign investors in exchange-control countries normally have to run the risk that they may be unable to "bring home" either their earnings or the principal initially invested.

MEASURES LIKELY TO PROMOTE FOREIGN INVESTMENT

Because the private foreign investments of the United States have lagged behind this country's capacity to lend and the willingness of the rest of the world to borrow, attention has come to be focused upon measures deemed likely to promote an increase in the volume of investment. Two suggested sets of measures appear especially noteworthy.

1. **Reduce Risk.** The suggestion is frequently made that the United States may promote private foreign investment by its residents by eliminating or lessening some of the risks which serve to deter the flow of capital. The risks in question are largely three-fold: (*a*) inability to repatriate principal and earnings because of exchange restrictions or other prohibitions imposed by the foreign government, (*b*) loss through expropriation, and (*c*) loss through war, revolution, or civil disorder.

Action by the United States to date covers two major lines of attack. First, this country from time to time negotiates treaties with foreign countries in order to clarify the rights of American investors in foreign countries and the type of treatment they may insist upon. The objective is to lessen or eliminate risk through assurance of conduct on the part of foreign countries not likely to prove injurious to American investors. The treaties are negotiated one at a time and differ slightly as between countries.

Second, this country provides insurance to cover specific risks assumed by private investors in the foreign field. At present, investments in new foreign projects or in the expansion of projects already in existence are eligible (if they meet prescribed criteria) for United States Government guarantees against the following risks: (*a*) inability to repatriate principal and earnings because of exchange restrictions or other prohibitions imposed by the foreign government, and (*b*) loss through expropriation by the foreign government. Guarantees are obtained for a fee from the Foreign Operations Administration acting through the Export-Import Bank

as its agent. Convertibility guarantees are limited to a return of principal and earnings over a maximum period of twenty years. Neither form of guarantee covers ordinary business risks, and neither is available when there is an "imminent" risk (i.e., guarantees are not issued when there is an impending likelihood of inconvertibility or expropriation). Important gaps in the present program include the absence of guarantees to directly cover war risks, long-established investments, and transactions involving use of short-term or medium-term credit. Guarantees are now available to cover eligible investments in only seventeen countries. It is significant that not all investors avail themselves of the guarantees for which they are eligible.

Two arguments are commonly advanced against the use of investment guarantees. First, some persons oppose government intervention in the foreign-investment field, even when the intervention is in the nature of a prop under private investment. These persons are inclined to argue that such intervention is merely a prelude to government control. Second, it is sometimes argued that the existence of United States Government guarantees serves to take pressure off foreign governments to promote economic and financial conditions conducive to an inflow of capital. If no guarantees exist, so it is argued, foreign countries must act to improve domestic conditions, or else suffer the stoppage of an inflow of new capital.

2. **Reduce Taxes.** It is frequently argued that the repatriated earnings of United States private foreign investments merit special treatment under this country's income tax laws. That is not to say that such earnings are now taxed twice, first by the foreign country and then by the United States. Such is not the case, for taxes paid abroad may, in general, be deducted from taxes payable in the United States. In almost all instances, however, the United States tax is higher than the foreign tax, so that the income recipient does make a payment to the United States. The argument that the repatriated earnings of private foreign investments be given special treatment generally takes either of two forms: (*a*) exemption from payment of taxes in the United States, or (*b*) taxation in the United States at a rate below that accorded income earned from domestic investments.

The proposal for exemption of foreign-earned investment income from payment of United States taxes is generally supported by two arguments. First, Americans investing abroad receive no direct benefits from the United States Government, and hence it is inappropriate to expect tax contributions from them. This argument is open to some question, especially since the prestige and laws of the United States are on occasion used to support the position of the investors. Second, exemption of

foreign-earned investment income from taxation in the United States puts the American investor more nearly on a par with other foreign investors who are exempted from taxation by their home governments. The proposal for outright exemption of foreign-earned investment income from taxation in the United States is not now under serious consideration and has not been in the recent past.

The second proposal — taxation in the United States of foreign-earned investment income at a rate below that accorded income earned from domestic investments — holds that those who invest abroad normally assume risks in addition to those assumed by domestic investors, and that this fact warrants the taxation of the income of the former at a lower rate than that applicable to the income of the latter. Some persons, of course, doubt the equity of such differentiated treatment, especially since they generally feel that there are advantages to foreign investment (e.g., higher returns per dollar volume of investment) which offset any alleged disadvantages. There is fairly general agreement, however, that such differentiated treatment, whether adopted on grounds of equity or "subsidy," may serve to promote the movement of private capital to foreign countries.

The present practice of the United States is to tax non-corporate income earned abroad at the prevailing personal-income-tax rates. Corporate income, when repatriated, is taxable under the prevailing corporate-income-tax rates, with the exception that earnings of so-called Western Hemisphere Trade Corporations are taxed at rates 14 percentage points below other corporate income. Western Hemisphere Trade Corporations are those corporations operating in the Western Hemisphere which are able to qualify for special treatment under the particular legislation. Thus, the customary tax rate for corporate income approximates 52 per cent, but those corporations qualifying as Western Hemisphere Trade Corporations are taxable at approximately 38 per cent. A recent proposal suggests that the special low rates, now available to one group of American corporations operating abroad, be made available to American corporations operating in any part of the world. In computing the United States tax liability, all foreign taxes paid are, in general, deductible from the liability, up to the full amount of the latter. This is true both for corporate and non-corporate income.

SUMMARY

A creditor country is one whose long-term and short-term foreign assets exceed its long-term and short-term foreign liabilities. Lending in excess of borrowing, if continued long enough, serves to turn a debtor

country into a creditor, while borrowing in excess of lending eventually turns a creditor into a debtor.

Capital is exported in the form of goods and services. The lending country puts purchasing power at the disposal of the borrowing country, which then enables the borrowing country to make purchases in the lending country (or in other countries if the loan is not "tied"). Repayment involves the same process, only in reverse. Thus, a creditor country must accept net imports of goods and services, unless it chooses to offset repayment through additional foreign investments of equivalent amount, or to regard its loans as gifts.

United States private and public foreign investments of all kinds totaled $39.5 billion at the end of 1953, while foreign investments in the United States totaled $23.6 billion; the United States was thus a net creditor by a margin of $15.8 billion. During the period 1946-53, the flow of private investment funds from the United States averaged $1.5 billion per year. Some persons believe that this amount is unduly low, considering the supply of capital available in this country and the "need" of the rest of the world for such capital. Factors frequently cited as constituting impediments to the flow of private capital from the United States include (1) the unfamiliarity of many potential investors with foreign investment, (2) the threat of war, (3) the trend to socialism, (4) the growth of nationalism, and (5) the transfer problem. Among the measures frequently proposed to encourage private foreign investment are the following: (1) the reduction of private risk by means of a system of guarantees handled by government (especially as related to the transferability of earnings and principal; loss through expropriation; and loss through war, revolution, or civil disorder), and (2) the stimulation of incentive by means of special tax treatment for the repatriated earnings from foreign investments.

SELECTED REFERENCES

°Buchanan, N. S., *International Investment and Domestic Welfare.* New York: Henry Holt & Company, Inc., 1945.

Iverson, C., *International Capital Movements.* London: Oxford University Press, 1936.

°Ohlin, B., *Interregional and International Trade.* Cambridge: Harvard University Press, 1933, Chaps. XVII, XX-XXI.

°U. S. Department of Commerce, *The United States in the World Economy*, Washington, 1943.

°———, *Foreign Investments of the United States,* Washington, 1953.

°———, *Study of Factors Limiting American Private Foreign Investment,* Washington, 1953.

16

Economic Development: I

During recent decades, the peoples of the relatively underdeveloped countries of the world have begun to clamor for economic development. Their growing demands that something be done rest upon a number of factors, the most important one of which probably is the realization of the peoples themselves of their own relative poverty. The more highly developed countries too have begun to take a greater interest in the problem, an interest stimulated by both economic and political factors. Tangible proof of this interest is found in such programs as the Point Four Program of the United States and the Colombo Plan of Great Britain, both inaugurated since World War II. (These programs are discussed in Chapter 19.)

This chapter discusses the meaning of the term "underdeveloped," the reasons for wanting development, and the objectives of this development. The following chapter treats additional aspects of the problem of economic development.

THE UNDERDEVELOPED COUNTRIES

What is meant by the statement that a country is "underdeveloped"? Economic development, or lack of it, is a *relative* proposition. It is apparent that not all countries are at the same level of development; some

are more developed, and others are less developed. The relatively less developed countries are said to be underdeveloped, i.e., they are underdeveloped in comparison to the more developed countries. For example, Brazil, China, and India are all underdeveloped as compared to the United States.

Generalized in a rough way, the underdeveloped portions of the world comprise much of Latin America, nearly all of Africa, much of the Middle and Far East, and parts of southern and eastern Europe; parts of such countries as the U.S.S.R. and Australia may perhaps also be included. In the foregoing areas live about two-thirds of the world's people.

THE DESIRE FOR ECONOMIC DEVELOPMENT

During recent years, the peoples of the underdeveloped countries have shown an unprecedented interest in economic development. While numerous factors have been responsible for this interest, undoubtedly the most important single factor, as we have already intimated, has been the fact that the peoples have become more fully aware of their own relative poverty. With this growing awareness has come deep dissatisfaction with the status quo and a fervent desire for improvement.

Numerous studies have been made in an attempt to ascertain the extent of the disparity in income and living standards between the underdeveloped and the developed countries. One set of estimates, presented to the United States Senate by the National Advisory Council, showed that in 1939 the fifteen most developed countries, comprising one-fifth of the world's population, had an average annual per-capita income of $461 (U. S. average=$554), while another group of ten countries, comprising one-sixth of the world's population, had an average annual per-capita income of $154, and a final group of twenty-eight countries, all underdeveloped, averaged but $41 per capita annually. A more recent set of estimates, prepared by the United Nations, showed that in 1949 per-capita income in the United States averaged over $1,400, that in fourteen other countries the per-capita average ranged between $400 and $900, and that in the remaining countries and territories, containing over one-half of the world's population, average per-capita income was less, and sometimes much less, than $400 (Fig. 10).

Other tests, too, show the relative poverty of the underdeveloped countries. For example, dietary, health, and educational standards all tend to be low. Per-capita food intake in many countries averages about 2,000 calories per day, or roughly one-third less than that of the United States. The typical diet is not only meagre, but it frequently lacks essential ele-

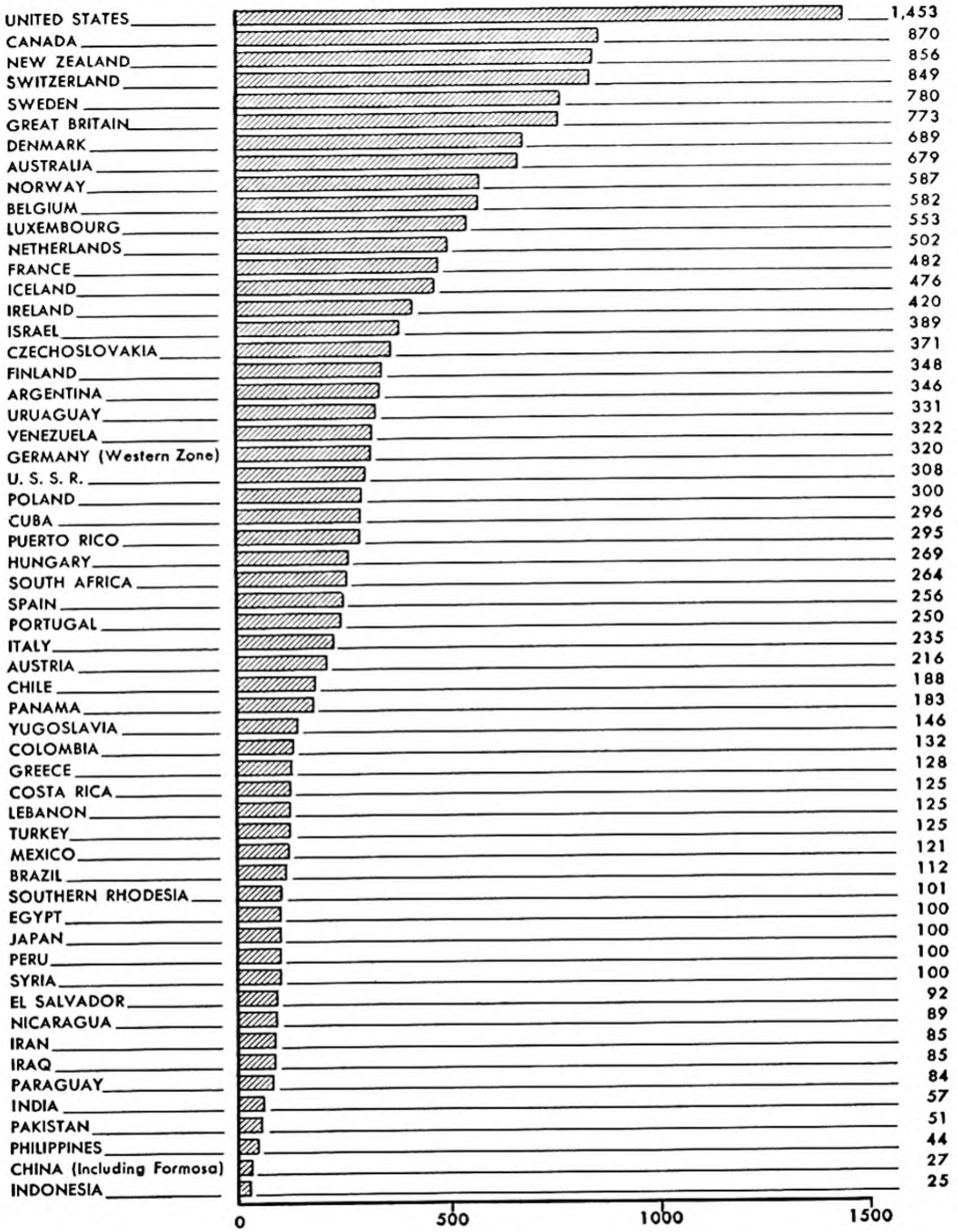


Figure 10

Per-Capita Incomes, Selected Countries, 1949
(1949 U.S. dollars)

Source: Based on data in UN, *National and Per Capita Incomes, Seventy Countries, 1949*, New York, 1950, Table 1, pp. 14-16.

ments, so that malnutrition is common. The poor diet, along with inadequate housing and the frequent lack of sanitation and medical facilities, creates an environment in which disease thrives. The infant-mortality rate is generally high, and average life expectancy is generally low. In 1939, life expectancy was only twenty-seven years in India, thirty years in Egypt, thirty-seven years in Mexico, and forty-seven years in Japan, compared to over sixty-five years in the United States. Similarly, illiteracy tends to be widespread, ranging from 50 to 90 per cent of the population over ten years of age in a number of the underdeveloped countries.

Second, the underdeveloped countries have come to desire a greater degree of economic independence for themselves. Underdeveloped countries in the great majority of instances are heavily specialized in the production and exportation of one or a relatively few raw-material products (primary goods), and depend upon importation for a variety of goods, especially manufactures, which they do not themselves produce. Such specialization serves to make the underdeveloped countries extremely dependent upon what transpires in the major countries in which their markets and sources of supply lie. If adverse conditions befall export markets, as is likely during a war or depression, the impact upon the underdeveloped countries tends to be serious.

By way of illustration, blockades and lack of shipping space during war periods frequently serve to cut off the underdeveloped countries from their export markets and from their sources of supply. Also, as the major industrial countries come to concentrate on the production of the implements of war, the manufactured goods needed by the underdeveloped countries are obtainable only with difficulty or not at all. Economic development is desired, therefore, to provide a basic core of national self-sufficiency.

Similarly, economic fluctuations in the major industrial countries have important implications for the underdeveloped countries. As national income fluctuates in the major countries, their imports from the underdeveloped countries also fluctuate. In fact, there is a tendency for imports to fluctuate even more than do incomes. Efforts by the underdeveloped countries to stimulate raw-material exports during recession or depression periods through resort to price reductions generally meet with little success, since the demand for these products generally is inelastic. Thus, during a recession or depression, the underdeveloped countries not only find that the foreign demand for their products decreases, but also that price reductions are of little avail in stimulating foreign sales. Under these conditions, when the major countries experience a recession or

depression, the export markets of the underdeveloped countries are severely depressed, entailing unemployment, foreign-exchange shortages, and a reduced volume of importation. The natural impulse within the underdeveloped countries, therefore, is to diversify in order to insulate against the impact of "foreign depressions."

Third, in addition to being subject to fluctuations induced by the state of affairs in the major countries, the underdeveloped countries have experienced, during roughly the past century, a relative deterioration in their export-import relationships. Specifically, as shown by a recent United Nations study, the ratio of prices of primary commodities to those of manufactured goods declined between the 1870's and World War II. With the same amount of primary products, only 63 per cent of the finished manufacturers which could be had in the 1870's were to be had in the 1930's; that is to say, an average of almost 59 per cent more primary products was needed in the latter period to buy the same amount of finished manufactures. During and after World War II, however, the terms of trade showed a slight improvement, e.g., the index rose from 62.0 in 1931-35 to 68.7 in 1946-47(1876-80=100).[1] The foregoing price indices were computed on the basis of average import and export prices; an important element not taken into account in the computations concerns possible quality changes, a pertinent consideration especially in the evaluation of manufactured goods over a period of time. Whatever shortcomings the indices may have, the significant fact is that concern over the alleged worsening of the terms of trade has led to proposals for alterations in the pattern of production prevailing within the underdeveloped countries. Two major approaches have generally been advanced: (1) a shift to the type of production likely to command more favorable prices in international markets, or (2) the development of types of production likely to free, or partially free, the underdeveloped countries of dependence upon relatively high-priced imports.

Interest in the economic development of the underdeveloped countries is in a sense a common interest, shared by both the underdeveloped and the more highly developed countries. The concern of the latter countries, such as the United States and Great Britain, is both economic and political. From an economic standpoint, the underdeveloped countries provide foodstuffs and industrial raw materials for the major countries. Without access to these products, production, income, and living standards in the latter countries tend to be seriously handicapped. In addition, the under-

[1] UN, *The Economic Development of Latin America,* New York, 1950, pp. 8-9. In this connection, see also C. Clark, *The Economics of 1960* (London; Macmillan & Co., Ltd., 1942), p. 54.

developed countries constitute markets for the output of the major countries. It is quite evident that it is difficult to market merchandise to peoples whose earnings are low. If the productivity (and, therefore, income) of the underdeveloped countries can be raised, the exports of the major countries can also be expected to increase, especially in view of the keenness of demand in the underdeveloped countries for the industrial products produced in the major countries. This view is supported by facts such as the following: the exports of the United States to the underdeveloped countries in the years immediately preceding World War II averaged but 70¢ per person annually, while exports to other, more highly developed countries averaged about $5.80 per person annually. Clearly, a primary essential for prosperous international trade is a relatively high level of production and income in the participating countries.[2] It is logical, therefore, for the major countries to support development within the underdeveloped countries on purely commercial grounds, provided such development occurs in accordance with the principles of comparative advantage.

The more highly developed countries may also have a political interest in the economic status of the underdeveloped countries. It is generally recognized that the underdeveloped countries tend to have the least stable governments, and that conditions of poverty provide fertile ground for the spread of totalitarian ideologies, either of the right or left. Recognition of the latter fact during the "cold-war" era following World War II led both the United States and Great Britain to support foreign programs of economic development in an attempt to counteract the spread of the communist philosophy. In an important sense, such expenditures for economic development represent an outlay in lieu of additional military expenditures. The foregoing conclusion rests upon the premise that there are two basic ways to attack the spread of communism: through a military program based upon force, or through economic expansion designed to raise the living standards of peoples, thereby making their minds less receptive to the appeals of communism.

THE OBJECTIVES OF ECONOMIC DEVELOPMENT

Economic development in underdeveloped countries may have either, or both, of two major objectives: (1) a higher level of income, or (2) a more stable level of income. A higher level of income, *per capita*, is

[2] For additional pertinent information on this point, see League of Nations, *Industrialization and Foreign Trade*, Geneva, 1945, Chaps. V-VI, and League of Nations, *The Network of World Trade*, Geneva, 1942, pp. 18-19.

dependent upon an increase in productivity (defined as greater output for effort expended). In some underdeveloped countries, an increase in productivity (and income) may be achieved through diversification, i.e., through the introduction of supplementary types of raw-material production or through industrialization. In other countries, however, diversification may be followed by a loss of productivity (and income); in such countries, an increase in productivity (and income) may be sought instead through the introduction of improved methods and equipment in connection with an intensification of existing primary-goods production. Whatever the method followed, only if productivity is increased is there a physical basis for raising per-capita income.

Even if economic development results in a loss of productivity (and income), action may nevertheless be justified, provided greater economic stability is thereby achieved, or provided the loss is only short-run. As previously indicated, the underdeveloped countries which are heavily dependent upon the exportation of one or a relatively few primary products are extremely vulnerable to repercussions arising abroad. In such cases, diversification may constitute a form of insurance, and any loss of productivity suffered in consequence may be viewed as an insurance premium paid for stability. A moderate loss of productivity may be a small price to pay for stability and an assured minimum domestic supply of basic foodstuffs and of minor industrial commodities of widespread use. Also, diversification entailing a loss of productivity may be supported if the loss is only temporary. The logic involved is similar to that used in supporting tariff protection for "infant industries": short-run losses become relatively unimportant if long-run gains are sufficiently great. In the case of diversification, the long-run gain may be measurable in terms of greater per-capita income, but the increase may not be realized until after a transition period of relative inefficiency during which lower per-capita income prevails.

MAJOR FORMS OF ECONOMIC DEVELOPMENT

The objective of economic development then is to raise the overall level of productivity and income (aside from those instances, relatively few in number, in which the stabilization of income constitutes the primary goal) by an amount that the average person comes to be better off economically. The central objective may be pursued in three distinct ways, either singly or in combination: (1) An attempt may be made to raise productivity through (*a*) improved health and education standards, (*b*) land and tax reforms, (*c*) new or improved public facilities, e.g.,

communication, transportation, and power facilities, and (*d*) other means, including changes in social mores, e.g., modification of customs and elimination of rigidities which impede economic change and occupational mobility. (Improvements of this type may be grouped under the general heading of "basic development.") (2) An attempt may be made to raise productivity in the existing fields of raw-material output through the introduction of new and improved methods and equipment. (3) An attempt may be made to direct manpower and resources into new fields of production, either through the diversification of raw-material production or through the introduction of industrialization, in the hope that productivity may thereby be raised. We may examine each of these methods.

"Basic Development"

"Basic development" refers to certain elementary and fundamental measures in the process of economic development. Some forms of basic development serve to raise productivity (and income) directly, e.g., improvements in the health and educational standards of the population which have the effect of raising the productive capacity of the individual. Other forms of basic development raise productivity (and income) indirectly in the sense that they lay the groundwork for additional development, e.g., the introduction or improvement of communication, transportation, and power facilities.

An introductory step in the economic development of many of the underdeveloped countries is an improvement in the health and literacy standards of their populations (sometimes referred to as an increase in "social capital," or simply as an improvement in the quality of their populations). Inadequate housing, poor sanitation and medical facilities, and an inferior diet all tend to foster disease and general ill-health. The poor health standards, along with widespread illiteracy which retards imagination and the development of skills, tend to hold the productivity of the labor force at a relatively low level. A dilemma exists, however, in that the low health and literacy standards serve to impede improvements in productivity, and low productivity (and income) in turn obstructs an improvement in health and literacy standards. A vicious cycle prevails: low productivity entails poverty, while poverty entails low productivity. If the cycle is to be broken, the status of the worker must be improved so that he may become more productive. Basic development enters the picture in that it stresses the need for an initial investment in the welfare of the people themselves in order that they may improve their health

and literacy standards, without which improvement low productivity and poverty continue to perpetuate one another.

It is significant that basic development, in so far as it pertains to improved sanitation, medical, and educational facilities, generally requires only a relatively small capital outlay, at least in comparison with other forms of development. Improvements in this direction, however, may operate to create a population problem in the sense that population growth may come to exceed the increase in the means of subsistence. (This matter is treated in the following chapter.)

Another introductory step in economic development, especially if it is to encompass industrialization, involves the acquisition of so-called "public overhead capital,"[3] i.e., communication, transportation, power, and other similar facilities. The case for the acquisition of public overhead capital is that such improvements are necessary in order to create an environment within which additional economic development may occur. Unfortunately, the underdeveloped countries frequently are not eager to undertake investments of this type. Since the countries are relatively capital-poor, the usual practice within them is to employ small amounts of capital in numerous small enterprises in the hope of obtaining the "end products" of industrialization in the immediate future. This practice is short-sighted, however, in that it ignores the fact that enterprises established in piecemeal fashion may be handicapped in their growth if, for example, the absence of adequate transportation facilities prevents ready access to supplies or markets, or a shortage of power prevents subsequent expansion on the part of those manufacturing enterprises which do begin operations.

The major deterrent to the acquisition of public overhead capital is the cost involved. The likely cost in the underdeveloped countries may be visualized through comparisons with the United States. About 40 per cent of all productive capital in the United States is invested in public transportation facilities and other public utilities.[4] Since the underdeveloped countries typically are highly deficient in public overhead capital, the drain upon their resources in the acquisition of such facilities may be expected to be relatively great.

Basic development may take a variety of additional forms. For example, in those countries in which a feudal agricultural system still prevails, land reform may serve to promote an increase in productivity.

[3] This term has been used by the IBRD to describe a particular category of basic investments.

[4] S. Fabricant, *Capital Consumption and Adjustment* (New York: National Bureau of Economic Research, 1938), pp. 248-9.

Again, modification or elimination of certain customs, e.g., the removal of a caste system, may provide a basis for change leading to an increase in productivity. Customs are not easily changed, however, and any progress in this direction tends to occur only over a considerable period of time.

Intensification of Raw-Material Production

A second form of economic development involves the use of new and improved methods and equipment in the present lines of raw-material production. In some underdeveloped countries, especially in those whose resource patterns are not favorable for either extensive diversification or widespread industrialization, the best alternative may lie in an intensification of effort in existing fields of raw-material production, agricultural or mineral, rather than in an attempt to shift manpower and resources into new and untried fields where per-capita productivity may actually prove lower.

Especially in agriculture, the adoption of any one of a number of simple and cheap reforms may result in substantial increases in output. For example, the practice of crop rotation may increase total yield as compared to the system of leaving land fallow. Improved farm equipment, such as steel plows instead of wooden plows or machine cultivators instead of hand hoes, may provide a relatively inexpensive method of increasing productivity. Better fencing may facilitate selective breeding, and thereby improve the quality of livestock. Other possible methods include the following: the introduction of improved methods of irrigation, erosion control, and pest control; the use of fertilizers; the use of better seed; and an improvement in marketing procedures and facilities.

It is frequently pointed out that if the peoples of the underdeveloped countries are shown how production may be increased, the new methods are likely to be adopted, provided the methods are simple and require only small capital outlay.

Diversification and Industrialization

In some underdeveloped countries, especially in those having abundant and varied resources, a third form of economic development — diversification — is generally possible. Such diversification may be of either of two types: (1) it may be limited to the development of supplementary forms of raw-material production, particularly of needed foodstuffs previously imported, or (2) it may involve industrialization, either as a supplement to or a partial replacement for existing raw-material production.

Diversification through resort to supplementary forms of raw-material

production, while sometimes abused by protectionist-minded groups in the domestic economy, ordinarily raises relatively few new economic problems. In the case of diversification through industrialization, however, the scope for abuse tends to be far greater, and the problems which generally arise are numerous.

Industrialization as it applies to the underdeveloped countries is frequently abused because of the tendency of the peoples to look upon it as a panacea for their ills. The peoples are aware of the wealth of the industrial countries, and are prone to conclude that an increase in wealth is certain to follow from industrialization in their case too. Such logic is, of course, quite faulty.[5] Industrialization results in increased wealth and in a higher standard of living only if the resources, labor skills, and market conditions are such that workers may be moved from activities of low productivity to activities of higher productivity. According to this test, the prospects for successful industrialization vary widely among the underdeveloped countries. It must be admitted, however, that in many of them the prospects are not very promising.

Assuming that industrialization is to be undertaken, a common problem which arises involves the shifting of workers into industry. In some underdeveloped countries this is no great problem, since a considerable portion of the labor force is normally utilized in relatively unproductive fashion. These workers, commonly engaged in various service-type tasks, constitute what is frequently referred to as the "disguised unemployed."[6] In meeting the needs of industry, some of the persons in the disguised-unemployed category can be drawn upon (or may replace others who do enter industry). The significant fact is that the shift of labor frequently can occur without need for a cutback in existing raw-material production.

In other underdeveloped countries, however, either no such labor reserve exists, or it exists only to a minor extent. In these countries, a problem arises in that the withdrawal of significant numbers from raw-material production serves to curtail food supplies (either because domestic food production declines, or because food imports decline as exports of other raw-material products are curtailed). In general, if the transition to industrialization in a country of this type is to be successful, the country must first build up its productive capacity in raw-material output so that labor can be freed for use in industry. In short, full-scale industrialization

[5] For an interesting discussion of this matter, see J. Viner, *International Trade and Economic Development* (Oxford: Clarendon Press, 1953), Chap. III.

[6] It is sometimes said of some of the underdeveloped countries that they have no unemployment, only a fluctuating body of "disguised unemployed," e.g., servants, lottery-ticket salesmen, and the like are more plentiful during depression than during prosperity.

must be preceded by an intensification of raw-material production. The latter may be circumvented, however, if foreign loans are used to finance imports during the transition period. Such loans may prove costly, particularly in the sense that the servicing and repayment of debt impose a burden upon the country during a period likely to be fraught with many difficulties. It may prove easier to borrow sparingly at first in order to intensify raw-material output, after which the more ambitious program of industrialization may be undertaken. In this way the problems of debt servicing and repayment may be largely avoided.

The Choice of Industries

If a program of industrialization is undertaken, what industries are to be selected? This is an important question because underdeveloped countries frequently appear tempted to "bite off more than they can chew." Rather than to "feel their way" into industrialization, the countries frequently desire, at the very outset, nothing short of the most complex or technologically advanced industries. Yet, great care must be exercised if the choice of industries is to be restricted to those which may later thrive in a competitive market, free of governmental supports.

There are three general categories of industries which hold promise, at least during the early stages of industrialization. In a first category are those industries which produce articles of widespread domestic consumption. Examples include textiles, shoes, soap, cement, cigarettes, and the like. In a second category are industries which undertake the elementary processing of raw materials in anticipation of export, particularly of those raw materials which are "weight losing" in nature and which may be shipped more cheaply if reduced in bulk. Examples include the reduction of mineral ores, the refinement of crude petroleum, and the elementary processing of sugar and cacao. Industries of this type may ordinarily be introduced with relative ease, representing as they do merely one additional phase in the process of preparing raw materials for consumption or for industrial use. In a third category are industries which assemble articles imported in knocked-down form. A good example is the erection of facilities for the assembling of automobiles. Even if a country is not able to sustain full-fledged heavy industry, the process of assembling knocked-down imports provides a basis for a portion of the industrial process to be gotten by the country. This method holds special appeal for manufacturers in the major industrial countries who may save on transport costs through the shipment of unassembled merchandise, and who may in this way avail themselves also of relatively cheap labor in the underdeveloped countries.

Industries of domestic origin included in the first category — the manufacture of articles of widespread domestic consumption — frequently need governmental protection if they are to take root and grow. The usual procedure is for the government concerned to extend them the helping hand of infant-industry tariff protection. Such assistance is economically justified if, after the expiration of a reasonable period, the individual enterprises become sufficiently proficient to permit their survival under free-market conditions. If the supported enterprises prove incapable of meeting this test, however, the country's standard of living suffers, since consumers are then forced to bear prices above competitive levels, not temporarily as initially intended, but permanently.

Tariff protection may also be employed to entice enterprises of this type, already producing in foreign countries, to establish operations in the tariff country. For example, after Australia imposed tariffs upon imports of finished textiles, an action ostensibly taken in order to encourage the growth of the domestic textiles industry, some British and Swiss textiles manufacturers saw fit to erect plants within Australia.

Tariff protection may also be employed to attract enterprises which assemble manufactured goods imported in knocked-down form. For example, Argentina long had in effect a flat tariff rate on the importation of automobiles. By establishing two tariff rates, one ad valorem rate upon imports of assembled automobiles and another, and lower, ad valorem rate upon imports of automobile parts, it became profitable for major automobile manufacturers to investigate the possibilities of establishing assembly plants within Argentina. The result was the acquisition of several such assembly plants. A somewhat similar set of circumstances led some automobile producers to establish plants within Canada.

In contrast, a tariff provides no help for countries seeking to attract enterprises which process goods for later export. In such cases, export taxes or prohibitions may have more to offer. For example, the Canadian provinces of Quebec and Ontario at one time exported pulp wood to the densely populated northeastern portion of the United States where it was processed for use as newsprint. Following the passage of legislation which prohibited the export of pulp wood from Crown lands, a sizable pulp and paper industry developed within eastern Canada. Similarly, Canada imposed export duties on hydroelectric power, thereby encouraging certain factories to locate on the Canadian side of the border rather than on the American side. Again, following the imposition of restrictions upon the exportation of high-grade iron ore from the Brazilian state of Minas Gerais, a sizable American-owned steel industry developed, despite the fact that coal had to be imported.

SUMMARY

The "underdeveloped" countries are those which are *relatively* less developed than others. For example, Brazil, China, and India are all underdeveloped in the sense that they are less developed than the United States. The underdeveloped portions of the world comprise much of Latin America, nearly all of Africa, much of the Middle and Far East, and parts of southern and eastern Europe.

The desire for economic development in the underdeveloped countries stems largely from the realization of the peoples of their own relative poverty. Dissatisfaction with the status quo has led them to expect something better. The more highly developed countries, such as the United States and Great Britain, are also interested in the economic development of the underdeveloped countries. From an economic standpoint, the underdeveloped countries constitute a source of supply and a market. From a political standpoint, the underdeveloped countries tend to be unstable, leading to situations of global importance.

Economic development has either, or both, of two major objectives: (1) a higher level of income (per capita), or (2) a more stable level of income. In order for per-capita income to rise, average productivity must be increased.

Economic development may take any one of three major forms: (1) an improvement in the quality of the population, or an improvement in the overall economic environment which, in and of itself, facilitates other growth, (2) an intensification of existing raw-material production, and (3) diversification, either through adoption of additional types of raw-material production or through industrialization.

SELECTED REFERENCES

See end of Chapter 17.

17

Economic Development: II

THIS CHAPTER continues the discussion of economic development begun in the preceding chapter. Included is a discussion of the obstacles to economic development, and a discussion of the topic "specialization versus diversification."

OBSTACLES TO ECONOMIC DEVELOPMENT

Economic development in the underdeveloped countries is frequently handicapped by the existence of powerful deterrents, political, social, and economic in nature. Generalization on this score is difficult, since conditions vary widely among the countries. Several factors, however, are sufficiently common among the countries and are of sufficient importance to warrant special mention here.

Lack of Natural Resources

The natural environment of a country is highly important in determining the type and amount of economic development which may likely occur. Some countries are much more favorably situated from the standpoint of climate, soil, and topography than are others. Also, the known resource potential per person is far greater in some countries than in

others. The situation can be summed up by saying that the blessings of nature are not evenly dispersed throughout the world. Those countries which are relatively more favorably endowed have an advantage from the very outset. For example, Brazil and Venezuela appear to possess relatively great potential for development as compared to, say, Antarctica and the regions of the Sahara. It appears, however, that few countries, if any, are as favorably situated as the United States from the standpoint of the natural ingredients of economic development (as gauged by known resources and present-day technology).

Those countries which do not possess a relatively favorable resource pattern may conceivably draw upon the resources of other countries in order to support their own economic development. Such development, of course, ordinarily occurs under a handicap, especially if the transport costs involved are substantial. Certainly, certain types of industries are precluded by such conditions.

Limited Markets

Industrialization frequently proves difficult in underdeveloped countries because of the limited size of the domestic market. Many of the countries are not populous to begin with, and all, whether densely or sparsely populated, tend to have relatively low per-capita incomes. The result is that the domestic demand for the output of a newly established enterprise tends in most instances to be relatively low.

It is sometimes argued that the process of industrialization is self-propelling. Thus, it is argued that industrialization gives rise to added income, which then helps underwrite the market for the output of the industries. In other words, "supply creates its own demand." As applied to the underdeveloped countries, however, the difficulty is that industrialization ordinarily does not occur simultaneously throughout the economy. The relative scarcity of capital, at least in comparison with the immensity of the requirements of industrialization, precludes development "all along the line." The usual procedure, rather, is to initiate projects "one at a time." A *single* industry, however, cannot ordinarily create a market for its own output. In short, what may be true under general industrialization is not necessarily true when industrialization is piecemeal.

If a start at general industrialization is not possible, either of two alternate approaches is frequently suggested as a means to initiate industrialization. The first involves a concentration of investment in communication and transportation facilities. An investment of this type has the effect of expanding the *domestic* market by linking parts of the same country more closely. In addition, the investment gives rise directly to

additional income which may bolster total demand. The second approach involves sales in *foreign* markets by new producers. This approach is of use, however, only if the domestic producers hold a comparative advantage and if transport costs do not prove overwhelming.

The Problem of Population

Proponents of economic development are quick to emphasize the beneficial effects it allegedly yields in raising productivity and income. Might not such gains, however, simply lead to an increase in population? And might not a growing population pushing against the means of subsistence simply leave the status of the average person largely unchanged? This is the general dilemma posed by "Malthusians" as they observe the teeming, poverty-stricken millions of some of the world's underdeveloped countries.

In undertaking an evaluation of the likely effect of economic development upon population growth, we need, first of all, to distinguish between those countries which are sparsely populated (relative to natural resources) and those which are densely populated. In sparsely populated countries, such as Brazil, Paraguay, Venezuela, and Australia, a moderate increase in population is likely to raise few new economic problems. But in the densely populated countries, such as China, India, and Java, the situation is quite different. There a real question arises as to whether the means of subsistence may be increased more rapidly than population, or even as rapidly. It is the latter situation which bears careful investigation.

It is widely agreed that an increase in the means of subsistence in the densely populated countries is likely to induce a further growth in population (due largely to declining infant-mortality rates and to greater longevity, rather than to higher birth rates). Persons holding this view generally cite what has happened to population in other countries following rapid economic development. For example, the experiences of the United Kingdom, Belgium, Japan, and other countries tend to bear out the contention that when the means of subsistence increase, population also tends to increase. It is significant, however, that one is hard-pressed to discover even a single case in recent history in which economic development has been accompanied for any considerable duration by a declining per-capita income. The usual situation, observable in the case of numerous countries, is that economic development is accompanied by a rising population *and* a rising per-capita income.

All this is not to say that there are no problems. Actually, many problems may be cited. For example, if economic development takes the form

of improvements in health conditions, and is unaccompanied by direct measures designed to increase the means of subsistence, there is danger that population may increase without any marked increase occurring in total production; hence, per-capita income may decline. It is for this reason that the particular point of emphasis in promoting economic development assumes major importance. Similarly, a special problem may arise during early stages of economic development. Population may increase (as high birth rates continue and death rates decline), but a marked increase in output may not be forthcoming in an immediate sense; therefore, per-capita income may decline temporarily. Again, it is possible for a country to reach a "saturation point" in the exploitation of its resources. Economic development, in the final analysis, can only pay dividends if the environment allows scope for operation.

Clearly, beyond a certain point a country must reconcile itself to one of three possibilities: (1) emigration, (2) birth control, or (3) a lower, and declining, average standard of living. A lower standard of living is not a valid alternative when economic development is the goal; the most that can be said for it is that it constitutes a consequence which befalls a country when all else fails. Nor does emigration necessarily offer a lasting solution for the population problems of a country. It can offer nothing more than temporary help unless the birth rate is held down to approximately the level of the death rate. If population growth continues unabated, emigration merely creates a "vacuum" which added numbers soon come to fill. The final possibility — birth control — is, accordingly, looked upon by many persons as the "great hope." Today, however, some of the countries whose population problems appear most acute also appear to be among those least sympathetic to the idea of widespread birth control. Whether or not birth control will come to be widely relied upon by countries in dealing with their population problems depends in part upon the spread of literacy, and in part upon the extent to which populations are willing to modify their present social customs and religious beliefs.

Low Volume of Savings

A major impediment to economic development in the underdeveloped countries is the low volume of domestic savings. Some countries, while not particularly deficient in raw materials or qualified people, nevertheless lack adequate savings to promote economic development. The amount of domestic savings in the underdeveloped countries is estimated at 5 per cent or less of national income, as compared to about 10 per cent in the

more highly developed countries.[1] The major reason for this relatively low rate is the generally low level of income which prevails.

Not only is the volume of domestic savings relatively low, but that which does occur frequently does not remain within the countries. It is common for private residents to move their funds to foreign countries where more convenient investment outlets prevail, or where the owners believe their holdings may be kept more safely. The problem today is that many of the underdeveloped countries lack both the organized capital markets, the presence of which might facilitate domestic investment, and the political stability needed to provide an incentive for such investment. It is not without significance that well-to-do residents of the underdeveloped countries invest in the United States or in other countries (i.e., they acquire foreign bank deposits, purchase the stocks and bonds of foreign corporations, etc.) at a time when their own governments are attempting to promote economic development and are, in some instances, contracting foreign loans for this very purpose.

Is there anything which an underdeveloped country can do to retain such domestic savings for domestic use? One method for accomplishing this end involves an improvement in the overall political and economic environment so that a resident may feel safe in investing funds within his own country. An essential element in such a new environment is political stability, but in so far as the latter may in itself depend upon further economic development, little progress may be expected in an immediate sense. A second method, involving compulsion, is increased income taxation. If residents insist upon moving their current savings out of a country, the government can eliminate much of the withdrawal simply by instituting a steeply progressive income tax. Persons cannot remove from a country that which they no longer possess. The "socialization" of the saving and investment functions, however, may solve one problem only to create others. For example, there is a question as to what is likely to happen to total savings (and income) if taxation serves to impair incentive. Also, there is a question as to how well a government is likely to handle funds which are channeled through it. Mismanagement of public funds is an old story in some of the underdeveloped countries; there is no assurance that funds accruing to some of the governments are used any more effectively than if left entirely in private hands. A third method, exchange control, also involves compulsion, although in a mild form as compared to taxation. In so far as a country's own nationals are concerned, exchange control offers a highly effective means for checking

[1] UN, *Measures for the Economic Development of Under-Developed Countries,* New York, 1951, p. 35.

an exodus of capital. Domestic investment of the desired types may not necessarily follow, but the likelihood of added investment occurring is increased when alternative opportunities outside the country are excluded.

It is one thing for an underdeveloped country to attempt to mobilize the savings which do arise domestically, but what if very little voluntary saving is forthcoming? In the latter case, the "inflation method" of financing is sometimes used. Under it, a country expands its money supply, generally through an expansion of bank credit (e.g., through loans to business or government). Such bank-credit creation has the effect of giving particular persons purchasing power which they did not previously possess, while reducing the *relative* share of total purchasing power held by the aggregate of other persons. As the total money supply is increased, the phenomenon of rising prices and lagging costs comes into operation. As wages (and also some other forms of current income) lag behind prices, the recipients of such income are able to lay claim to a lesser share of total current output than previously. In essence, the recipients of loans are able to lay claim to current output at the expense of wage-earners (and some others). This is the process of "*forced saving*"; since wage-earners, and others, do not choose to save voluntarily, they are "forced" to save in the sense that their relative share of total purchasing power is decreased (i.e., they are able to buy less goods and services because prices have gone up more rapidly than have their incomes). The fact that those who comprise the bulk of the consumer sector of the economy hold a smaller share of total purchasing power, along with the fact that potential investors hold a larger share of total purchasing power, serves to divert productive effort from the production of consumer goods to the production of investment goods.

The inflation method of financing, however, is open to several criticisms. First, inflation tends to lower the average standard of living, or to prevent it from rising as rapidly as otherwise possible. The incomes of consumers do not keep pace with prices, so that real incomes are adversely affected. Second, domestic inflation tends to lower the volume of exportation, thereby raising questions as to how needed imports are to be financed. Third, the prospect of a rising price level makes it difficult to promote supplementary long-term financing in fixed-interest securities. Fourth, domestic holders of funds, fearful of financial ruin under inflation, may seek refuge in property investments, which may then be held in relatively unproductive fashion, or may seek to shift their funds to countries offering greater price stability.

Is the amount of domestic capital which is ordinarily available, or

which may be generated through forced saving, sufficient to finance economic development? The answer to this question depends in large part upon the scope and pace of the developmental program which is contemplated. A program designed to raise the health and literacy standards of the population or the level of output in the existing fields of raw-material production ordinarily requires only a relatively small capital outlay as compared to, say, a program of industrialization. Similarly, the immediate demand for funds may be kept relatively low, provided a country is willing to spread economic development over a prolonged period. If, however, a country wishes to undergo substantial development over a relatively short period of time, and also wishes to maintain the consumption standards of its population in the interim, foreign borrowing is essential in order to augment limited domestic resources.

THE COST OF ECONOMIC DEVELOPMENT

How much is the economic development of the underdeveloped countries likely to cost? One answer is found in a report prepared by a group of experts appointed by the United Nations. According to this group, *annual* developmental outlays required in the underdeveloped countries in order to increase per-capita national income by 2 per cent annually exceed \$19.0 billion (Table 25).[2]

Domestic savings in the countries surveyed are shown to have amounted to about \$5.2 billion in 1949. Thus, on the basis of a total need of \$19.0 billion, the deficiency in domestic savings totals almost \$14.0 billion annually. If the full \$19.0 billion required is to be raised domestically, domestic savings must total 20 per cent of national income, in contrast to 5 per cent in 1949. Considering the relative poverty of the countries, a savings rate much in excess of 5 per cent is not a likely development. If it is proposed to raise abroad the amount of the domestic deficiency, the prospects do not appear bright either. The sum of \$14.0 billion annually looms large in comparison to the amounts of capital received by these countries in their past history. The annual inflow of capital in the underdeveloped countries averaged not over \$0.5 billion during the 1920's. The current inflow, including grants, does not exceed \$1.5 billion annually, and is probably not much over \$1.0 billion. According to calculations of the United Nations group, the current rate of investment in the underdeveloped countries (on the basis of domestic savings and foreign capital) is sufficient to raise per-capita national income by only about ¾ of 1 per cent annually.

[2] The calculations allow for probable population growth.

Table 25

Capital Required by Underdeveloped Areas Annually in Industry and Agriculture to Raise Their National Income Per Capita by 2 Per Cent Annually
(millions of dollars)

Area	National Income, 1949	Net Domestic Savings, 1949	Needed for		Total Needed	Deficit ("Total Needed" minus "Net Domestic Savings")
			Industrialization	Agriculture		
Latin America	24,000	1,990	1,580	960	2,540	550
Africa, excluding Egypt	13,200	720	1,780	528	2,308	1,588
Middle East, including Egypt	9,000	540	940	360	1,300	760
South-central Asia	24,000	1,200	4,360	960	5,320	4,120
Far East, excluding Japan	26,400	790	6,610	1,056	7,666	6,876
Total	96,600	5,240	15,270	3,864	19,134	13,894

Sources: UN, *Measures for the Economic Development of Under-developed Countries,* New York, 1951, Table 2, p. 76.

COMPETITIVE INDUSTRIALIZATION

A common fear, frequently expressed in the United States and elsewhere, is that when a leading industrial country lends to, or invests in, the younger and underdeveloped countries, it is "cutting its own throat" in that it is helping to build up foreign competition which serves eventually to reduce its markets in the borrowing countries, to create competition in the markets of third countries, and perhaps even to subject the lending country's domestic market to a flood of competitive imports. This view generalizes what may be true in specific cases, but it ignores much of what is relevant. It is frequently true that foreign economic development does harm some *particular* firm or industry in the lending country. The particular firm or industry whose position has been, or is likely to be, adversely affected may, of course, on the grounds of narrow self-interest, denounce the loans or investments which lead to foreign competition.

The really important consideration, however, concerns the effect of competitive industrialization, not upon a particular firm or industry, but

upon the *economy as a whole.* The fact is that the economy of the lending country, aggregatively considered, tends to gain, not lose, from foreign economic development, provided the economy is flexible and is willing to adjust to the new situation. If these conditions are present, the adjustment process creates only temporary economic disturbances and is followed by a generally improved economic situation. Specifically, once an adjustment is completed, there tends to be a more effective utilization of productive effort all around.

SPECIALIZATION VERSUS DIVERSIFICATION

International-trade theorists frequently advance the argument that an international division of labor is economically justified because it leads, not only to a greater volume of goods and services for total effort expended, but also to a greater volume of goods and services for *each* country willing to specialize and trade. In recent years, however, some economists, particularly economists in the underdeveloped countries, have come to challenge this proposition. They are inclined to hold that the above represents a fine *theory*, but that it doesn't work out in *practice* as pictured. For example, a recent United Nations publication of note states that "reality is undermining the out-dated schema of the international division of labor."[3] Economists who hold this view point to the fact that underdeveloped countries typically do specialize and trade (in fact, generally to a relatively great extent), but that they are rewarded for their efforts neither by a relatively high level of per-capita income nor by relative stability in the domestic economy. These economists are therefore inclined to doubt the merits of specialization; instead, they talk of the alleged merits of diversification, and particularly of the gains possible from industrialization.

The first question which arises concerns the level of per-capita income in the underdeveloped countries. It is a fact, of course, that the prevailing per-capita income is at a relatively low level in these countries. Diversification *may* serve as the means to increase income, but then again it may serve to reduce it below prevailing levels. The pertinent point is that the law of comparative advantage is as valid today as ever (for reasons cited in Chapter 1 and elsewhere in this book).

A second question which arises concerns the lack of economic stability in the economy of the typical underdeveloped country. The instability arises basically because of specialization. Production is generally heavily

[3] UN, *The Economic Development of Latin America,* New York, 1950, p. 1. (This study was prepared by Professor Raul Prebisch, an internationally known economist of Latin America.)

concentrated in one or a relatively few raw-material products. This, in turn, leads to large-scale exportation of "surplus" output. Exports, however, are dependent upon foreign markets. The domestic economy, therefore, becomes vulnerable to fluctuations arising in foreign markets. While a few underdeveloped countries do not fit this pattern, the great majority of them do.

The "rub," however, is that the underdeveloped countries which conform to this pattern — specialization plus large-scale exportation — can do very little on their own accord to counteract their vulnerability to repercussions arising abroad. That is, they can do very little as long as they remain undiversified raw-material producers. Realization of this fact serves to stimulate the desire for diversification.

The following pages are devoted to a theoretical discussion of why undiversified raw-material-producing countries tend of necessity to experience economic instability, and why the countries can do very little on their own accord, short of diversification, to offset this instability.

The Role of Exports in Income Determination

Economic theorists rely heavily upon the so-called "income analysis" in their efforts to explain the level of and the fluctuations in economic activity. In this analysis, the level of national income (Y) at any time is pictured as equal to the combined consumption (C) and investment (I) expenditures of the immediately preceding time period (or, $Y=C+I$). Since C may be shown to undergo fluctuations which are less than proportional to changes in Y, a satisfactory explanation of the fluctuations in Y must necessarily rest basically upon changes in the magnitude of the other component in the formulation, i.e., upon I. Hence, I holds the key as to whether Y rises or falls. A high level of I is conducive to a high level of Y, and vice versa. There is, however, a further important relationship, namely, that which exists between saving (S) and I. Thus, it may be shown that when planned current I (representing additions to the money stream) exceeds planned current S (representing subtractions from the money stream), the level of Y rises; or, if planned current S exceeds planned current I, the level of Y falls. While the terms in the S-and-I relationship are subject to definition, and while the analysis itself is frequently the subject of academic controversy, it is generally held that the national-income formulation provides a tool which enables us to explain the level of and the fluctuations in domestic economic activity.

As initially presented, the formulation $Y=C+I$ referred to a "closed" economy (i.e., one having no foreign-trade relations), so that C and I referred only to the domestic economy. If the analysis is to be made

applicable to an "open" economy (i.e., one having foreign-trade relations), international transactions must be taken into account. Accordingly, the formulation must either define C and I in such a way that they include imports (M) and exports (X), respectively, or the formulation must add foreign-trade items as follows: $Y = C + I + X - M$. The closed-economy approach is perhaps not too far-fetched when applied to those countries, such as the United States, which are relatively self-sufficient. Greater realism, nevertheless, is attained when international transactions are included to supplement factors of a purely domestic nature. In primary-goods-producing countries, which are generally heavily dependent upon foreign trade by virtue of their extreme specialization, however, purely domestic factors, though by no means unimportant, frequently tend to be of relatively less importance in the economy. In view of unique environmental factors, therefore, a change of emphasis in the basic theoretical formulation becomes necessary in their case. Thus, while investment may be looked upon as the factor which generates national income in the American economy, a similar role is played by exportation in the economies of the underdeveloped countries. Not only is exportation relatively more important than domestic investment as a determinant of the level of economic activity in their case, but the amount of domestic investment itself comes to be determined largely by the level of export trade and the state of foreign exchange. Export trade thus becomes the most important single element for explaining fluctuations in the level of economic activity in a primary-goods-producing, "export-type" economy.

Although not as heavily dependent upon the international economy as are some countries, foreign trade nevertheless is important to the United States. In this country, however, foreign trade shares with the domestic investment function the role of determining the level of economic activity. If exportation undergoes a drastic decline, there still exists the strictly domestic lever of investment to rely upon. Even Great Britain, although heavily dependent upon foreign trade, is sufficiently diversified to allow domestic measures to be pursued in order to mitigate somewhat the effect of a loss of foreign markets. In the case of a highly specialized primary-goods-producing country, however, the situation is quite different. Because of exportation which is both large-scale and largely undiversified, the oscillations in export volume tend to produce unusually sharp repercussions within the domestic economy. If pronounced price variations occur, or if foreign demand fluctuates widely, the basic export industries, which are themselves limited largely to the production and sale of one or a relatively few major agricultural or mineral commodities, may readily be

thrown into depression. Because of their dominant role in the economy, their plight is soon shared by supplementary industries, which in an important sense are mere satellites. Depression in the key industry or industries is thus quickly transformed into general depression.

The Inadequacy of Fiscal Remedies

If the level of income in the domestic economy tends to fluctuate with variations in exportation, may not a country adopt internal measures to offset the adverse effects which arise in the international economy? The United States, for example, has in the past attempted to bring about and maintain a high level of national income through a government investment program, used on occasion to supplement private investment (i.e., through the use of compensatory-fiscal-policy measures). May not a primary-goods-producing country similarly strive to offset reductions in national income through resort to fiscal-policy measures? The answer is that government contra-cyclical policies have been difficult to apply in the case of primary producers, precisely because of the heavy dependence of the latter upon foreign trade. Let us analyze this situation.

According to economic theory, an initial investment expenditure results in a series of secondary expenditures, so that the total effect of a new investment expenditure upon national income is some multiple of the initial expenditure (except if all added national income is immediately saved). The multiplier effect of an investment upon national income is limited only by the fact that some portion of income received at each stage is saved and thus constitutes a "leakage" from the income stream. In short, investment tends to create national income, but saving tends to limit the process of income creation. Applying this analysis to the United States, we find that, since the economy is relatively self-contained, the secondary income effects of an investment program accrue in high degree to the benefit of domestic industries. In an export-type country, however, the economy is geared to international trade and the secondary income effects of an investment program accrue largely abroad. If the government of such a country spends money on public works, for example, in the hope of arresting the decline in national income which follows a shrinkage in exportation, one of the first results is an increase in importation. In an export-type economy, it is exportation rather than domestic investment which comprises the chief variable affecting income, and it is importation rather than saving which comprises the main "leakage" from the income stream.

Why does an investment program in an export-type economy tend to increase importation rather than to build up the domestic economy? The

answer is found basically in the specialized nature of production, a specialization geared to exportation. A domestic investment program cannot generate a foreign market but, in the absence of a well-rounded domestic economy, it does tend to create a demand for goods which are obtainable only through importation. For example, the major equipment needs in connection with domestic investment are normally filled through foreign purchases, leading to a further drain upon already depleted exchange reserves. If an investment program actually results in the generation of income domestically, the results are equally unfortunate. Since the industrial capacity of the typical primary-goods-producing country tends to be small, an increase in income soon creates a need for a greater volume of consumer-goods imports or a need for additional domestic productive capacity. Induced investment arising on the latter score also leads to increased importation as investment funds come to be spent abroad for capital goods unobtainable at home. In such an environment the role of compensatory-fiscal policy is destined to be incidental. Not until a country achieves a certain degree of economic "balance" can it seriously hope to employ a domestically sponsored fiscal-policy program as an effective contra-cyclical device.

It may be concluded that if a primary-goods-producing country engages in a public-works program (or in some other form of expansionist program) which promotes a higher level of importation than otherwise likely to prevail, it is advanced foreign countries such as the United States and Great Britain which benefit, but only minutely by virtue of the small impact upon a large economic entity. If, on the other hand, the United States pursues domestic policies which promote full employment and a high level of national income, the maintenance of a large and steady flow of importation serves to underwrite income in the primary-goods-producing countries. It is evident, therefore, that the initiative for a successful fiscal program for maintaining a high and stable level of national income must come from the major countries. Prosperity in the leading countries is the best assurance of prosperity in the primary-goods-producing countries. This is how matters stand under present circumstances.

SUMMARY

Obstacles to the economic development of the underdeveloped countries are numerous. Generalizations are difficult because of the large number of countries involved, but some of the more important obstacles include the following: (1) a deficient resource pattern in many of the countries, (2) relatively small markets in most of the countries (which

hampers the development of large-scale output), (3) overpopulation, plus "explosive" population growth, in many of the countries, (4) a shortage of domestic savings with which to finance development, and (5) access to an insufficient volume of foreign capital.

Economists have long argued that international specialization and trade tend to promote a higher standard of living in the participating countries. Many persons in the underdeveloped countries, however, have come to question the results of specialization as they apply to their economies. Most underdeveloped countries are specialized, but the average level of income is neither high nor stable. An increase in the average level of income, of course, is dependent upon an increase in productivity. Unfortunately there is grave doubt whether an abandonment of the present specialization can result in anything but lowered income in the case of some of the underdeveloped countries. An abandonment of specialization — resort to diversification — may, however, serve to promote a more stable level of income. Specialization leads to large-scale exportation; in consequence, domestic welfare becomes dependent upon the status of export markets. Diversification, in making a country more nearly self-contained, can reduce the extent of vulnerability to economic repercussions arising abroad.

SELECTED REFERENCES

Adler, J. H., *The Underdeveloped Areas: Their Industrialization.* New Haven: Yale Institute of International Studies, Memorandum No. 31, 1949.

Gordon, W. C., *The Economy of Latin America.* New York: Columbia University Press, 1950, Part III.

°Hoselitz, B. F. (ed.), *The Progress of Underdeveloped Areas.* Chicago: University of Chicago Press, 1952.

League of Nations, *Industrialization and Foreign Trade,* Geneva, 1945.

Staley, E., *World Economic Development.* Montreal: International Labor Office, 1944.

°———, *The Future of Underdeveloped Areas.* New York: Council on Foreign Relations, 1954.

°United Nations, *Measures for the Economic Development of Underdeveloped Countries,* New York, 1951.

°———, *The Economic Development of Latin America,* New York, 1950.

°Viner, J., *International Trade and Economic Development.* Oxford: Clarendon Press, 1953, Chap. VI.

18

The International Bank for Reconstruction and Development

IN JULY, 1944, an international conference was held at Bretton Woods, New Hampshire, attended by delegates from most non-Axis countries. Following lengthy discussion of economic problems likely to confront the world following World War II, agreement was reached concerning two proposed international organizations. One was the International Bank for Reconstruction and Development; the other was the International Monetary Fund. The United States Congress approved membership in both organizations through passage of the Bretton Woods Agreement Act of 1945. Shortly thereafter, following approval by numerous other countries as well, the two new organizations came into existence, both with headquarters in Washington.

The purposes of the International Bank for Reconstruction and Development (commonly referred to as the IBRD, or the Bank) were set forth in the Articles of Agreement in the following language: (1) "To assist in the reconstruction and development of territories of members. . . .", and (2) "To promote private foreign investments by means of guarantees or participations in loans and other investments made by private investors; and when private capital is not available on reasonable terms, to supplement private investment by providing, on suitable conditions, finance for

production purposes out of its own capital, funds raised by it and its other resources."

The idea of loans for "reconstruction" appealed to those countries, specifically Western European countries, which had suffered war damage, while the idea of loans for "development" appealed to the underdeveloped countries. Although some reconstruction loans were made, it was apparent almost from the very outset that the IBRD was not prepared to cope with the problem of reconstruction. The IBRD's resources were too limited, and the scheduled lending procedure was inappropriate, for the task at hand. Consequently, alternate arrangements were soon made to deal with the reconstruction problem. Of greatest single importance, the United States Congress put into effect the Marshall Plan, under which program this country extended reconstruction aid in a volume far in excess of the lending capacity of the IBRD. Freed of the problem of reconstruction, the IBRD became an institution concerned solely with long-term lending for developmental purposes.

WHY AN "INTERNATIONAL" BANK?

International lending had long occurred on either a private or an intergovernmental basis. Why then should a new *international* lending agency suddenly have been proposed? The answer to this question is found in the fact that most countries, including both the prospective borrowers and the likely lenders, felt that international lending could be handled in a more satisfactory manner with an international bank than without it.

The potential borrowers, comprising most countries other than the United States, were quite aware that the great preponderance of loan funds during the post-World War II years would have to come from the United States, the only country in a position to support large-scale international lending. There was widespread fear, however, that the United States would fall victim to an erratic loan policy. Specifically, it was felt that the volume of lending by the United States would fluctuate with the level of domestic prosperity, as had been the case in the past. In this period of history it was widely believed that the United States would likely experience a postwar recession, the effect of which would be to cut off loan funds at a time when they were badly needed abroad. The potential borrowers, therefore, sought to assure themselves of a minimum supply of loan funds which would continue to be available, regardless of the lending policies in effect in the United States. In addition, the fact that an international bank would not be tied to a single country served to remove the old bugaboo of control by "imperialist" lending countries.

Though funds lent through an international bank might arise largely in one or few countries, control over lending would be vested in the hands of many countries, including both creditors and debtors.

Similarly, the United States, although quite aware that it would continue to supply the bulk of international loan funds, stood to gain by the creation of an international bank. First, loans from an international bank would not necessarily replace lending by the United States, but could be made *supplemental* to such lending. Second, risks stemming from the loans of an international bank, even if the capital for such loans originated in the United States, would be borne internationally, i.e., by all the member countries, rather than by a single country.

ORGANIZATION OF THE BANK

Every country is eligible for membership in the Bank, provided it subscribes to the Charter of the Bank, and provided it also becomes a member of the companion institution, the International Monetary Fund (which has power over monetary and exchange-rate matters). From a membership of forty-four countries at the outset, the Bank has expanded to include fifty-six countries. Most major countries are members. Important non-members include the U.S.S.R., Switzerland, and Argentina.

The authorized capitalization of the Bank is $10.0 billion, divided into 100,000 shares of $100,000 each. Each member is assigned a quota (based on each country's relative economic importance) which, in turn, provides the basis for its subscription. Total subscriptions of present members slightly exceed $9.0 billion.[1] The subscription of the United States is $3.175 billion (35 per cent of the total subscription), while Great Britain (14 per cent), China (7 per cent), France (6 per cent), and India (4 per cent) are other large subscribers.

The total subscription is divided into two parts: (1) Only 20 per cent of each member's subscription is actually paid in (2 per cent in gold or United States dollars, and the remaining 18 per cent in the member's own currency). (2) The other 80 per cent remains subject to call, but in the interim serves to guarantee the Bank's own obligations (i.e., its own bonds, or its obligations incurred in guaranteeing private loans).

The official hierarchy of the Bank consists of a Board of Governors, a Board of Executive Directors, and a general staff. The Board of Governors, consisting of one governor (usually the finance minister of the member country) and one alternate appointed by each member country, is concerned with broad policy matters and meets annually in Wash-

[1] Subscriptions totaled $9,148.5 million as of June 30, 1954.

ington for a few days. The Board of Executive Directors, which meets weekly, consists of sixteen directors. Each director represents a country or group of countries, and each holds voting power in proportion to the shares held by his constituents.[2] The powers of the Board of Executive Directors, as they relate to the general operations of the Bank, are largely those entrusted to it by the Board of Governors, which meets too infrequently to fully implement its decisions. The most important personage on the Bank's staff is the President, who is in charge of administration. Power centers in the staff since the latter handles all loan negotiations. It is the function of the staff to evaluate all loan applications, and to make recommendations to the Board of Executive Directors for final action. Staff members are recruited internationally; some thirty member countries are currently represented.

FINANCES OF THE BANK

In theory the Bank is a lender of last resort. The general rule is that the Bank intervenes only if it is satisfied that the borrower is qualified, but cannot get a loan elsewhere on reasonable terms. This is in keeping with the principle that the Bank is to supplement, rather than to supplant, existing credit facilities.

The total lending capacity of the Bank is limited to the amount of total subscriptions plus reserves and surplus. Since only 20 per cent of the subscription is paid in, the Bank's ability to lend on this basis is not great. It was never intended, however, to confine the Bank's lending operations to this amount. The Bank may also lend on the basis of proceeds from the sale of its own bonds, and it may promote private lending through its guarantee of loans. An examination of each of these three types of lending operations may provide a fuller understanding of the Bank's role in the international investment field.

1. **Direct Loans from the Bank's Own Funds.** The Bank may lend its own funds, consisting of the paid-in subscriptions of members (i.e., 20 per cent of total subscriptions) plus any reserves and surplus which may be accumulated. Of the paid-in capital, the 2 per cent represented by gold may be used for any purpose, but the remaining 18 per cent represented by the member's own currency may be lent only after approval by the subscribing country. This provision gives members control over the

[2] Each member country has 250 votes plus one additional vote for each $100,000 of subscribed capital. Thus, the United States, with 32,000 of 105,485 votes, has 31 per cent of the total voting strength, and Great Britain, with 13,250 votes, has 13 per cent of the total voting strength.

lending of currencies supplied by them; once lent, however, members have no power to control the withdrawal of funds by debtors.

Amortization and interest payments are required to be in currency of equivalent value to that borrowed. The pertinent provision in the Articles of Agreement reads as follows: "These payments . . . shall be equivalent to the value of such contractual payments at the time the loans were made, in terms of a currency specified for the purpose by the Bank by a three-fourths majority of the total voting power."[3] This provision precludes repayment in terms of a depreciated currency.

2. Direct Loans from Funds Borrowed by the Bank. The Bank is empowered to float its own bonds (commonly known as "World Bank bonds") and to lend the proceeds. The Bank, however, must obtain the approval of the country in which it wishes to market its bonds. In addition, if loans are to be denominated in terms of a currency other than the one circulating in the country in which the bonds are marketed, the approval of the currency country is also required. The Articles of Agreement provide that the Bank may borrow funds (or guarantee loans) "only with the approval of the member in whose markets the funds are raised and the member in whose currency the loan is denominated, and only if those members agree that the proceeds may be exchanged for the currency of any other member without restriction."[4] Without such approval, the possibility exists that member countries may not "honor" claims for goods and services which grow out of the credit operations of the Bank. If approval is obtained, however, the currency raised by the Bank becomes freely convertible, and neither the "lending" country nor the currency country has further control over withdrawals.

Loans of the Bank, when made from borrowed funds, are not to be held payable in a particular currency in an amount greater than the Bank's own borrowings in that currency. For example, if the Bank raises dollars in the amount of $1.0 billion through sale of bonds in the United States, it is not to allow its outstanding loans payable in dollars to exceed this amount (over and above the paid-in subscription of the United States). This provision is intended to protect the balance-of-payments positions of countries which might otherwise be forced to repay in, say, scarce dollars an amount greater than the Bank's own obligations expressed in that currency.

The demands upon the Bank to date have been largely for United States dollars. In order to supplement its supply of dollars, the Bank

[3] Art. IV. 4.
[4] Art. IV. 1.

has sold its own bonds in the American market. (Smaller blocks of securities, denominated in pounds sterling, Canadian dollars, Netherlands guilders, and Swiss francs, have also been offered.) There has been no difficulty in finding buyers for the bonds. In addition to their yield, which is slightly above that of United States Government bonds, World Bank bonds have the attraction of being gilt-edged. The bonds are backed 100 per cent by the capital of the Bank, as well as by the IOU's of the borrowers. Since the United States is obligated to the full amount of its subscription, or $3.175 billion, all Bank bonds up to this amount are in effect guaranteed by the United States Government. If the marketing of the Bank's securities is ever to become a problem, it is apparent that this is not likely to occur before (if then) total Bank bonds outstanding exceed $3.175 billion. This point does not appear imminent, since bonds outstanding on June 30, 1954, totaled only $776.7 million.

3. Guarantees. Prospective borrowers who are unable to obtain funds elsewhere on reasonable terms may apply for a loan from the Bank. If the Bank is so disposed, it may choose to extend a loan from its own funds, or it may refer the applicant back to the private capital market, but in so doing may agree to guarantee in whole or in part the loans occurring through private investment channels. The Bank, however, guarantees such loans only after obtaining the approval of the country in whose markets the funds are raised and of the country in terms of whose currency the loan is denominated. Once such approval is obtained, the individual countries have no further control over either the convertibility of a currency or the rate and manner of withdrawal.

It was widely believed at the outset that the guarantee of private loans would constitute the major portion of the Bank's business, but little use has been made of this method to date. By mid-1954, loans guaranteed by the Bank only slightly exceeded $100 million, about 5 per cent of the Bank's total volume of lending operations.

LOAN OPERATIONS

We may examine some aspects of the lending operations of the Bank in order better to understand and appraise the institution's role in the international investment field.

1. Who May Borrow from the Bank? Any member country is theoretically eligible to borrow any sum up to the full amount of the Bank's lending capacity, irrespective of the size of the particular member's subscription, subject to the limitation that the total loans and guarantees of

the Bank to all member countries may never exceed total subscriptions plus surplus and reserves.

While the Bank is free to lend to private persons or enterprises located within member countries, most loans are to member governments or agencies thereof. Few private loans are negotiated through the Bank since, according to the Articles of Agreement, these must be guaranteed by the member government concerned. Most member governments are reluctant to obligate themselves financially in this manner, either because of their unwillingness to throw themselves open to possible charges of favoritism, or because of their unwillingness to assume the risks of others over whose activities they have less than complete control. On the other hand, private borrowers frequently fear government guarantees which they believe may invite close government control.

2. Lending Procedure. Upon receipt of a formal loan application, a preliminary investigation is undertaken by the officials and staff of the Bank. If the application appears to warrant serious consideration, the applicant is informed that a further investigation is to be made. The Bank then customarily sends a technical mission to make an on-the-spot check and to report its findings. The mission concerns itself especially with the economic potentialities of the proposed project or program, its overall implications for the particular economy, and the probability of its proving self-liquidating. The report of the mission is studied by the staff of the Bank, and if a favorable decision is reached, and if the applicant has not been able to secure funds elsewhere on reasonable terms, the loan proposal is submitted to the Executive Directors for final action. Following the granting of the loan, officials of the Bank check periodically to make sure that the borrower uses the funds for the purposes stipulated in the loan agreement.

3. Lending Policy: Five Criteria. Before granting (or guaranteeing) a loan, the Bank customarily first assures itself that at least five conditions exist:

First, the borrower is unable without the intervention of the Bank to obtain the funds needed under reasonable conditions. The practice of the Bank is not to compete with private investors.

Second, the borrower is unable (after "proper efforts") to raise the required funds domestically.

Third, the borrower is regarded as a good credit risk. The Bank operates under an obligation to pay "due regard" to the prospective capacity and willingness of the borrower or guarantor to meet interest and

amortization payments.[5] In practice, this rule raises two questions for the Bank: (*a*) Is the project or program likely to prove self-liquidating in terms of the currency of the borrowing country? (*b*) Is the borrowing country likely to possess sufficient foreign exchange to allow transfer of interest and amortization payments? In assessing repayment prospects, the main consideration, according to the President of the Bank, is the "willingness and ability of the country concerned to follow economic policies which will enable it to earn enough foreign exchange to pay its debts."[6]

Fourth, the funds in question are scheduled for use in connection with the "more useful" and "urgent" projects or programs.[7]

Fifth, the borrower is equipped technically, financially, and administratively, to carry out the project or program.

The Bank's policy, in principle, is to make both "project loans" and "program loans." In practice, virtually all loans by the Bank are for *specific* projects; however, some program loans, covering a portion of the cost of projects (unspecified) of a larger program, do occur.

The Bank generally lends only enough to cover the foreign exchange required in connection with the project or program. That portion of the cost which does not require foreign exchange generally must be financed with funds obtained domestically.

4. **Total Loans.** Total loans of the Bank amounted to $1,914.4 million through June 30, 1954. This total encompassed 104 loans in 34 countries. Loans for "reconstruction," totaling $497 million, were made to countries of Western Europe during 1947, before the inception of other loan facilities for this purpose. Since then loans have been solely for "development," and have totaled $1,417 million. The geographic distribution and purposes of IBRD loans are summarized in Table 26.

5. **Loans Not Tied.** Loans made by the Bank are not tied, i.e., the loan proceeds may be used for purchases in any country the borrower selects. This provision is in keeping with the Bank's avowed objective of promoting multilateral trade.

6. **Interest Charges.** The interest rates on loans by the Bank are relatively low, especially when compared to rates prevailing in most of the borrowing countries. A uniform rate applies to all borrowers, although there are slight variations depending upon the duration of the loan and

[5] Art. III. 4.

[6] Statement by Eugene R. Black, President of the IBRD, appearing in "Policies and Operations of the World Bank," *Lloyds Bank Review*, July, 1953, p. 23.

[7] *Ibid.*

Table 26

International Bank Loans, by Purpose and Area
(millions of U.S. dollars, net of cancellations and refundings; June 30, 1954)

Purpose	Total	Area				
		Asia and Middle East	Africa	Australasia	Europe	Western Hemisphere
Reconstruction loans	497	. . .	. . .	. . .	497	. . .
Developmental loans:	1,377	232	199	204	285	457
Electric power	509	63	88	33	35	290
Transportation	397	86	71	74	63	103
Communications	26	2	. . .	. . .	. . .	24
Agriculture and forestry	167	47	. . .	71	29	20
Industry	168	32	. . .	26	90	20
General development	110	2	40	. . .	68	. . .
Total	1,874	232	199	204	782	457

Source: IBRD, *Ninth Annual Report, 1953-1954*, Washington, 1954, p. 12.

upon the cost to the Bank of its borrowed funds. Rates typically range from 3½ to 4½ per cent annually.

7. **Commission Charges.** In addition to an interest charge, the Bank collects a commission of 1 to 1½ per cent per year on all transactions (both loans and guarantees), the charge being applicable to the amount of the loan still outstanding. The purpose of this charge is to permit the accumulation of a reserve from which losses may be met. The existing rates are to continue for the first ten years of the Bank's operation, after which they may be raised or lowered on new loans and guarantees, depending upon the reserve position of the Bank.

8. **Repayment.** The Bank's provisions allow considerable flexibility in handling the problem of repayment. A hard-pressed debtor country may request a relaxation in the terms of repayment, and such a request is generally granted if the Bank feels that circumstances warrant special treatment. For example, the Bank may agree to modify the terms of amortization or to extend the duration of the loan. Or, in the case of a member experiencing pressure upon its exchange rate, the Bank may agree to accept repayment in the member's own currency for periods up to three years, provided the debtor agrees (*a*) to allow the Bank to use its currency, (*b*) to maintain the foreign-exchange value of its currency, and (*c*) to repurchase its currency on appropriate terms when able to do so. The flexibility of loan terms constitutes one of the outstanding features of the Bank's operation which distinguishes it from earlier private lending.

APPRAISAL OF THE BANK

Most economists would readily agree that the Bank has been a success up to a point. The Bank can claim credit for projects which came into being through use of capital supplied by it. In addition, the Bank can claim credit for having aided borrowers and potential borrowers through the rendering of technical advice on investment and on economic and financial matters related to investment.

Despite its achievements, the Bank is not without its critics. Among criticisms offered, two appear outstanding.

1. **Failure to Stimulate Private Investment.** One of the hopes which led to the establishment of the Bank was that its presence might serve to stimulate the flow of private capital to the underdeveloped countries. An increase in private foreign investment, it was anticipated, would occur because of (*a*) the Bank's willingness to guarantee private loans, and (*b*) the Bank's own development loans which would open up new investment opportunities for private foreign capital.

The experience of the Bank during the postwar years, however, indicates that its success in stimulating private foreign investment was only limited at best. The aggregate volume of private capital moving to the underdeveloped countries during these years, as we have previously observed, remained far short of the needs of these countries for external assistance. The failure of the Bank in this connection rests upon the fact that it did not evolve as a large-scale guarantor of private capital. Virtually all of the Bank's financial operations have involved direct loans out of its own resources or out of funds borrowed by it; little use has been made of the Bank as a guarantor of private loans.

Few private borrowers chose to request the Bank to guarantee loans contracted in private capital markets. The fact that a private borrower was required to obtain the guarantee of his government served to discourage applications. Borrowers were reluctant to become indebted to their governments in this fashion, and the governments, in turn, generally have been extremely cautious in extending such guarantees.

The major deterrents to private foreign investment, however, are outside the scope of the Bank. These deterrents, as we have previously observed, include political and economic instability, discriminatory treatment, and other factors which serve to make the investment climate less attractive. The Bank can do little, if anything, about these deterrents; but not until the overall environment in the underdeveloped countries is

conducive to large-scale private investment can the Bank hope to make fuller use of its powers in guaranteeing private loans.

2. **Small Volume of Lending.** The fundamental purpose of the Bank has been, and is, to assist in the economic development of underdeveloped countries. During its first eight years of operation, the Bank lent a total of about $1.0 billion to the underdeveloped countries. Comparing this figure to the United Nations experts' estimate, previously cited, of about $10.0 billion of outside capital required annually to raise per-capita income in the underdeveloped countries by 2 per cent per year, it becomes apparent that the Bank's lending has been a mere "drop in the bucket."

Why does the Bank not lend in larger quantity? Basically, the relatively low volume of lending is the result of a conservative lending policy. This conservatism is evident in several respects. First, the philosophy of the Bank is to promote private lending, rather than to support high-volume lending of its own. The President of the Bank stated the Bank's position in the following terms:

> Measured against the total of international investment, the Bank's lending can never be more than marginal. . . . The Bank sees its main task as that of encouraging the flow of private capital. . . .
>
> The emphasis . . . is not on what the Bank itself can lend, but on ways in which it can stimulate the growth of investment nationally and internationally.[8]

In short, the Bank is pictured as an instrument for "priming" private investment. However, as we have previously intimated, the Bank probably cannot be called a success on the basis of the encouragement it has given private investment to date.

Second, the officials of the Bank hold to the opinion that the strategic factor limiting economic development in the underdeveloped countries, whatever it is, is not a shortage of capital. According to a report of the Bank, "Perhaps the most striking single lesson which the Bank has learned in the course of its operations is how limited is the capacity of the underdeveloped countries to absorb capital quickly for really productive purposes."[9] The opinion is that capital, to be employed effectively, must have an appropriate environment within which to work. Capital is a necessary condition for development, but not the only necessary condition. Unless the prevailing social, political, and economic conditions allow economic growth to occur, capital cannot be used to good advantage. The pertinent point, of course, is that the environment prevailing in many underdeveloped countries is not conducive to economic growth.

[8] *Ibid.*, pp. 32, 19.
[9] IBRD, *Fourth Annual Report, 1948-1949*, Washington, 1949, p. 8.

Third, the scope of operations of the Bank is limited by virtue of certain rules (and the interpretation of them by the Bank). Policy-wise the Bank is ready to make either project loans or program loans; the crucial consideration in either case is whether the loan is likely to prove "productive." Unfortunately, this rule raises difficulties. On the one hand, many projects, viewed in isolation, do not meet the test of being productive; on the other hand, "overall development" (as distinct from a "project-by-project" approach) may be essential if large-scale growth is to occur, but loans of this type (even though permitted) frequently are not productive on the basis of the Bank's standards. The result is that the really big investments upon which economic development very often depends are largely ruled out by the Bank's rigid standards, leaving only "fringe" investments, so to speak, to the Bank.

If the Bank were to adopt a more liberal lending policy, a dilemma of another sort would probably arise. The Bank's total lending capacity is limited to an amount only slightly in excess of $9.0 billion. Under relaxed lending regulations, and considering the demand of most of the underdeveloped countries for external capital, such an amount would likely soon be exhausted. If this dilemma did arise, however, the Bank's resources could presumably be enlarged.

Most economists would probably argue that a "happy medium" is needed somewhere between the present conservatism of the Bank and the extreme view of those who are inclined to hold that "large loans can solve all things."

SUMMARY

The International Bank for Reconstruction and Development was one of two international institutions which grew out of the Bretton Woods Conference of 1944. The Bank was proposed because it was felt existing lending facilities were not adequate for the needs of the post-World War II era. The Bank's initial purposes were two-fold: (1) to aid in the "reconstruction" of war-damaged countries, and (2) to aid in the "development" of underdeveloped countries. The reconstruction problem proved so enormous that other provisions (e.g., the Marshall Plan) were soon made to cope with it, leaving the Bank free to concentrate on lending for economic development alone.

The Bank has an authorized capital of $10.0 billion, of which slightly over $9.0 billion has been subscribed (only 20 per cent of which is actually paid in). The Bank is empowered to lend to members from its own funds and from funds secured through the sale of its own bonds, or it may

guarantee loans negotiated in private capital markets. The theory behind the formation of the Bank was that it was to be a lender of last resort, lending only if the prospective borrower was unable to obtain funds elsewhere on reasonable terms. In practice, however, the Bank's power to act as a guarantor of private loans has been little used. Most loans to date have been from the Bank's own funds (either from paid-in capital or from funds raised through the sale of World Bank bonds). While the Bank is free to lend in any amount up to the total of member subscriptions plus surplus and reserves, its loans during the first eight years of operation totaled only slightly over $1.9 billion.

To the extent that the Bank has lent for economic development, some projects not otherwise possible have come to be initiated in underdeveloped countries. In addition, the Bank has aided borrowers through its rendering of technical advice on economic matters. Nevertheless, some important criticisms have been made of the Bank. The charge is made that (1) the Bank has failed in its objective to stimulate private investment, and that (2) the Bank's own lending has been of relatively insignificant proportions.

SELECTED REFERENCES

°Black, E. R., "Policies and Operations of the World Bank," *Lloyds Bank Review,* July, 1953.

°Halm, G., *International Monetary Cooperation.* Chapel Hill: University of North Carolina Press, 1945, Chap. XIII.

°International Bank for Reconstruction and Development, *Ninth Annual Report, 1953-1954,* Washington, 1954. (See other annual issues.)

———, *The Economic Development of British Guiana.* Baltimore: Johns Hopkins Press, 1953. (Report of an IBRD mission. Similar reports have been made on other countries, including Ceylon, Colombia, Cuba, Guatemala, Iraq, Jamaica, Nicaragua, and Turkey.)

19

Experiments in Economic Development

DURING RECENT YEARS a number of proposals have been made and a number of organizations have begun operations which have had as their objective the economic development of the underdeveloped countries. The IBRD, previously discussed, constitutes one of the more important efforts to date. In addition, we may cite the following: (1) the United States Export-Import Bank; (2) the Point Four Program, instituted by the United States to render technical assistance to the underdeveloped countries; (3) the Colombo Plan, instituted by the British Commonwealth countries to promote economic development in South and Southeast Asia; (4) the so-called "fomentos," or government-sponsored developmental corporations, in Latin America; (5) important private efforts, such as the International Basic Economy Corporation; (6) the proposed International Finance Corporation, designed to provide equity capital abroad; and (7) the proposed Special United Nations Fund for Economic Development, designed to provide public funds on a grant or long-term, low-interest basis for non-self-liquidating projects. This chapter presents an outline of each of these programs or proposals.

THE EXPORT-IMPORT BANK

The Export-Import Bank of Washington had its beginnings in February, 1934. Its immediate purpose was to finance trade with the U.S.S.R.

(following this country's diplomatic recognition of the U.S.S.R.). This objective was never achieved since the United States and the U.S.S.R. were unable to reach agreement regarding the settlement of debts and claims. While negotiations were in progress, however, another (but smaller) Export-Import Bank was established to finance trade with countries other than the U.S.S.R. Early in 1935, once it had become apparent that negotiations with the U.S.S.R. had ended in failure, the Export-Import Banks were reconstructed into a single Bank, which institution has continued in existence until the present time.

The avowed purpose of this Export-Import Bank, as stated in its charter, was "to aid in financing and to facilitate exports and imports and the exchange of commodities between the United States and other nations or the agencies or nationals thereof. . . ." Actually, the Bank has had two major interests over the years: (1) the stimulation of United States exports as part of a domestic anti-depression program, and (2) the granting of credit in order to implement United States foreign policy.

During early years of operation, the Bank's relatively small resources were used largely to finance this country's lagging exports, especially its agricultural exports. As international tensions mounted during the late thirties, the sphere of action of the Bank was expanded to allow it to render financial assistance to foreign governments, thereby putting the Bank in a position to reinforce United States foreign policy. Lending during the ensuing period was largely to China and Latin America (implementing the "Good-Neighbor Policy" in the latter instance). In 1940, the Bank's resources were expanded and its purposes defined in a manner so as to allow a fuller implementation of this country's foreign policy, especially as it pertained to assisting Latin-American countries in the promotion of their programs of economic development. Beginning in 1945, following another increase in the Bank's resources, loans were made to Western Europe for reconstruction, in addition to those made to underdeveloped countries for purposes of economic development. In 1951, the Bank's resources were again increased, largely in response to pressure for a more active role on the part of the Bank. During 1953-54, recession conditions within the United States, plus growing competition from European exporters in foreign markets, served to evoke considerable interest, somewhat as during the mid-1930's, in the liberalization of credit facilities as a means to stimulate the volume of exportation. One result of this rising interest was a further increase during 1954 in the Bank's capital, giving it total lending resources of $5.0 billion.

Type and Magnitude of Loans

In the main, the Bank makes three types of loans. First, it makes *exporter loans* (i.e., loans to United States exporters who require credit not obtainable elsewhere on reasonable terms). The Bank may either lend directly or guarantee private loans. The Bank's general policy is to supplement lending by private banks rather than to compete for business. Second, the Bank makes general *loans to foreign governments.* Much of the Bank's lending during the early post-World War II period fell into this category (although confined largely to the countries of Western Europe). Third, the Bank makes *project loans* to foreign borrowers. These are loans for the financing of specific projects (as distinct from general loans) undertaken either by government or by private persons or enterprises. Private borrowers must ordinarily obtain the guarantee of their government. Typical projects financed by the Bank include small factories of various kinds, cement plants, slaughterhouses, and hotels. Although not specifically required by law, the Bank's lending typically is on a tied-loan basis.

The cumulative lending of the Bank through December 31, 1953, totaled \$6.5 billion, of which amount \$4.6 billion was actually disbursed, and \$1.7 billion was repaid. The great bulk of the lending occurred after World War II. Total loans between mid-1945 and the end of 1953 amounted to \$5.2 billion, as compared to only \$1.3 billion during the entire eleven-year period up to mid-1945; in fact, \$2.2 billion of the total lending occurred during the first year following the end of World War II in Europe. Total credits authorized for major areas were as follows (through December 31, 1953): \$2.2 billion for Latin America, \$1.0 billion for Asia, \$2.8 billion for Europe, \$0.4 billion for Canada, and \$0.2 billion for Africa. Over sixty countries benefited directly from the credit of the Bank. Slightly over one-half of all the Bank's lending can properly be classified as having been for "economic development"; much of the remainder can be attributed to "reconstruction" in Europe following World War II. The Bank's total loan authorizations of \$5.2 billion between mid-1945 and the end of 1953 may be compared with (*a*) total loans of \$1.9 billion by the IBRD during roughly the same period (Table 26, Chapter 18), (*b*) a dollar deficit of the rest of the world with the United States during 1946-53 of \$32.1 billion (Table 23, Chapter 14), and (*c*) a need for external capital in the underdeveloped countries in excess of \$10.0 billion per year (Chapter 17).

Evaluation of the Bank

The Bank has not been without its critics. A frequent point of controversy concerning the Bank involves the terms upon which exporters are to receive credit. American manufacturers frequently state that they are unable to sell abroad in competition with foreign exporters (generally British or German firms) who allegedly are backed by their domestic equivalents of the Export-Import Bank to an extent unmatched by the Export-Import Bank. The usual argument is that the Export-Import Bank does not offer credit of sufficient duration, or that the standards for determining eligibility are too rigid or severe. The result is periodic pressure, especially during recession periods when exportation is hard hit, for a more liberal Export-Import Bank policy. To what extent more favorable treatment is economically justified is a difficult matter to determine. Many factors must be considered, including the practice of foreign export-credit institutions, and the degree to which credit liberalization may be consistent with sound finance in the United States. Some persons, however, are skeptical of any liberalization, pointing out that in all probability some exporters merely desire an outside institution to "bail them out" of difficulties attributable to any number of possible factors, including their own inefficiency.

A second criticism frequently heard is that loans by the Bank to foreign governments are colored by political considerations. If such is true, this fact is good or bad, depending upon how one chooses to evaluate the situation. It can be argued that when a government agency lends abroad, it must of necessity, because of the role of government in today's hectic world, take political considerations into account. Others are prone to argue that economic considerations alone should determine the advisability or inadvisability of foreign lending. Whatever the case may be, it is important to realize that one of the reasons the Bank's lending capacity was expanded was to implement United States foreign policy.

A third criticism sometimes made is that the Bank adheres to too conservative a policy in lending for specific projects in foreign countries. The Bank ordinarily loans only the amount needed to cover the foreign-exchange portion of the cost of a project (and then the loan is customarily "tied" so that the proceeds can be spent only in the United States). Moreover, the Bank's standards for determining eligibility are relatively high, and many types of projects, even when adjudged "sound" by other tests, simply cannot be financed through use of the Bank's resources. On the other hand, the Bank's present lending capacity (virtually all resources are lent) perhaps does not warrant a lending policy far different from the

one in effect. Also, the Bank's conservative lending policy has paid off in the sense that there have been virtually no losses to date.

Probably the strongest argument to be made in favor of the Bank is that its lending, though limited because of adherence to conservative standards, has helped initiate and promote developmental (and recovery) projects in various countries. Bank funds very often are matched (or even exceeded) by local funds in the joint financing of specific projects. The very fact that the Bank is willing to extend credit frequently serves to activate domestic capital. In this way, the Bank serves to "prime" investments which would not otherwise occur.

THE POINT FOUR PROGRAM

In his inaugural address of January 20, 1949, President Truman discussed four courses of action which he believed of paramount importance in the formulation of a foreign economic policy for the United States. The fourth of these points (hence, "Point Four") dealt with the rendering of technical assistance to underdeveloped countries. In part, he stated as follows:

> We must embark on a bold new program for making the benefits of our scientific advances and industrial progress available for the improvement and growth of underdeveloped areas.
>
> Greater production is the key to prosperity and peace. And the key to greater production is a wider and more vigorous application of modern scientific and technical knowledge.[1]

The President's statement received widespread support, both in the the United States and abroad. During the subsequent year Congress incorporated the general principles he had outlined in the Foreign Economic Assistance Act of 1950. Title IV of this law, labeled an "Act for International Development," contained the following policy statement:

> . . . it is declared to be the policy of the United States to aid the efforts of the peoples of economically underdeveloped areas to develop their resources and improve their working and living conditions by encouraging the exchange of technical knowledge and skills and the flow of investment capital to countries which provide conditions under which such technical assistance and capital can effectively and constructively contribute to raising standards of living, creating new sources of wealth, increasing productivity, and expanding purchasing power.

The legislation which established the Point Four Program envisaged the promotion of economic development in the underdeveloped countries

[1] *Department of State Bulletin,* January 30, 1949.

through the rendering of *technical assistance* by the United States. For purposes of the program, technical assistance was defined as technological *know-how* (including technical advice, technical training, and demonstration equipment). Such technical assistance was to be transmitted through two media: (1) *cooperative* ventures between the United States and individual underdeveloped countries (hence, Point Four is sometimes referred to as a program of *technical cooperation*), and (2) United States support of the technical-assistance services offered by the United Nations and its specialized agencies.

The "grass-roots" approach to economic development which the Point Four Program envisaged was not expected to prove particularly costly. In any event, the budgets devoted to the program have never been large. For example, during fiscal year 1954 appropriations for the support of *bilateral* technical-assistance programs undertaken by the United States and individual cooperating countries totaled \$98.5 million, while contributions to the technical-assistance programs of the United Nations and its specialized agencies (i.e., contributions to so-called *multilateral* programs) totaled \$8.5 million, a combined total of \$107.0 million. Cumulative expenditures by the United States for Point Four through June 30, 1954, totaled as follows: bilateral programs, \$252.4 million; multilateral programs, \$28.7 million; total, \$281.0 million.

Operation of Point Four

The first comprehensive program under the Point Four Program, an integrated health, agricultural, and educational program for improving living conditions in rural villages in Iran, was formalized through a bilateral agreement signed in October, 1950. By April 1, 1954, programs were under way in thirty-eight countries (Table 27).

Among other things, the technical-assistance programs under Point Four include the following types of activity: studies of economic problems, especially in an attempt to determine potential lines of development; furnishing advisers and technicians to governments, private organizations, and private businesses in connection with development projects; participating, financially and administratively, with foreign governments in projects essential to economic development; development of demonstration projects; providing on-the-job training; assisting technical schools and universities; providing for in-service training of foreign nationals in the United States; and furnishing library and film materials on matters related to economic development.

The total amount spent within the participating countries in consequence of Point Four is somewhat in excess of the United States expendi-

Table 27

Countries Receiving Assistance Under the Point Four Program
(April 1, 1954)

Near East, Africa, and South Asia	
Afghanistan	Jordan
Egypt	Lebanon
Ethiopia	Liberia
India	Libya
Iran	Nepal
Iraq	Pakistan
Israel	Saudi Arabia
Far East	
China (Formosa)	Philippines
Indochina	Thailand
Indonesia	
Latin America	
Bolivia	Haiti
Brazil	Honduras
Chile	Mexico
Colombia	Nicaragua
Costa Rica	Panama
Cuba	Paraguay
Dominican Republic	Peru
Ecuador	Uruguay
El Salvador	Venezuela
Guatemala	

Source: Information supplied by Foreign Operations Administration.

ture indicated above. This is the case because participating governments frequently contribute local funds to supplement United States funds in carrying out specific undertakings (i.e., the programs frequently are *cooperative* ventures in a financial sense as well as in an administrative sense).

The "Bold New Program"

The Point Four Program is frequently referred to as a "bold new program." Bold the program may someday become, but new it is not.

The idea of "exporting" technical assistance from the United States dates at least from the era of the Good-Neighbor Policy, which had its inception in 1933.[2] As part of this country's program of "hemispheric

[2] Smaller programs had been undertaken even earlier, e.g., the Boxer indemnity funds set up some thirty years earlier as an aid to education.

solidarity," two important international conferences were held during the thirties (the Inter-American Conference for the Maintenance of Peace, held in Buenos Aires in 1936, and the International Conference of American States, held in Lima in 1938) at each of which the twenty-one American republics formally declared their desire to increase the interchange of scientific, technical, cultural, and educational knowledge. Out of these conferences grew a law, adopted by Congress in 1939, which authorized the President to carry out reciprocal undertakings and cooperative agreements in accordance with the principles established at Buenos Aires and Lima. The passage of this Act was followed, first, by the creation of an Interdepartmental Committee on Scientific and Cultural Cooperation under the chairmanship of the Undersecretary of State and, next, by the establishment of the Office of the Coordinator of Inter-American Affairs.

In 1942, the Institute of Inter-American Affairs, organized as a governmental corporation, was established as an outgrowth of the Office of the Coordinator of Inter-American Affairs. The purposes of the Institute, as set forth in the authorizing legislation, were to further the general welfare of the peoples of the American republics and to strengthen friendship and understanding among them. The achievement of these objectives was sought through close collaboration among the governments and governmental agencies of the American republics in planning, initiating, assisting, financing, administering, and executing technical programs and projects, especially in the fields of public health, sanitation, education, and agriculture. Each program or project undertaken by the Institute was to be embodied in a bilateral agreement, known as a "basic country agreement," entered into between the United States and the participating government.

To even the most casual observer, the principles underlying the program of the Institute of Inter-American Affairs and the Point Four Program appear strikingly similar. Under the circumstances, it is difficult to maintain that the Point Four Program is founded on a "new idea."

While the idea of Point Four may not be new, the program is different in that it is more ambitious. First, Point Four offers technical assistance on a much larger scale. Point Four encompasses not only Latin America, but also reaches into Africa, the Middle East, and the Far East, where millions of additional people living in underdeveloped countries are covered. Second, despite the fact that Point Four is not a "big money" program, altogether larger sums of money are allotted to it than was true in the case of the Institute of Inter-American Affairs. In short, the Point Four Program differs from earlier programs mainly in scope.

Evaluation of Point Four

The Point Four Program has as its major objective an improvement in the average standard of living in the underdeveloped countries by means of the dissemination and application of the technological and scientific know-how of the United States. To what extent is it possible that this objective may be realized? A definitive answer is difficult on the basis of the program's relatively short period of operation. We are able, however, to point out some of the criticisms already made, as well as to state some of the conditions which presumably must be met if success is to follow.

1. **"Humanitarianism" is Not Enough.** Advocates of Point Four frequently cite the poor health and sanitation standards of peoples in underdeveloped countries. These persons are prone to emphasize the "humanitarian" aspect of Point Four, frequently with considerable fervor. While there is general agreement that improved health and sanitation are desirable in many of the countries, there is considerable difference of opinion as to the type of program needed to achieve lasting benefits.

According to one approach, teams of physicians, nurses, and public health people are sent into the field, while rather incidental attention is paid to other aspects of the problem. The likely consequence of this procedure is that public health is improved, the incidence of disease is lessened, mortality rates are cut, and average life expectancy is lengthened, but economic output (the production of the means of subsistence) may rise too slowly to give increased numbers of people the benefits of a substantially improved standard of living.

It is desirable that a population be given something more than life without adequate subsistence. It appears wise, therefore, that a health program, especially in the case of a densely populated underdeveloped country, be accompanied by other efforts designed primarily to raise the level of production, so that more people may be supported in better fashion. In fact, the effect of an increase in production is to underscore a public health program as higher incomes make possible better dietary and housing standards.

2. **Resource Exploitation.** There is always a possibility that a developmental program financed by a foreign power may be used to the advantage of the lending country and to the detriment of the recipient country. For example, such a program may conceivably evolve as an instrument for the cultivation of sources of supply of strategic raw materials for the lending country. If the sources of supply are developed to cater to transitory requirements within the lending country, as may readily

occur during a period of rising international tensions and growing remilitarization, the effect upon the underdeveloped countries is unfortunate in that their economies come to be shaped to meet specific short-run export demands. If long-run developments prove at variance with these short-run demands, the underdeveloped countries are likely to find themselves with excess capacity in specialized export industries, entailing serious economic and political consequences for them.[3] Only to the extent that economic development under a program such as Point Four proceeds along lines which give rise to benefits over considerable time may a positive gain be said to accrue to the underdeveloped countries.

3. The Cost of Economic Development. Point Four is not a "big money" program. Some phases of economic development may, of course, be approached on a modest budget, but others require relatively heavy outlays. This means that Point Four of necessity is limited to particular phases of the process of economic development.

The basic function of Point Four is to render technical assistance. A program limited to this task tends ordinarily to prove relatively low-cost. A problem exists, however, in the sense that technical assistance, in order to be used effectively within the underdeveloped countries, must in many instances be accompanied by expenditures for other forms of economic development. The underdeveloped countries frequently do not have sufficient capital to support supplementary expenditures, with the result that Point Four assistance, unaccompanied by other efforts at development, may be used less effectively than otherwise possible.

Beyond technical assistance lies a type of economic development which is far more costly. Industrialization, for example, requires know-how plus capital expenditures on equipment and supplies ordinarily obtainable only through importation from more highly developed countries. The present budget of Point Four cannot support such outlays, nor indeed is this the purpose of the program.

Point Four must of necessity remain aloof from the costly forms of economic development. The program is designed to tackle only one small phase of the overall problem of economic development. If substantial

[3] A case in point is the joint effort of the governments of the United States and Haiti during World War II (through "SHADA," a government corporation jointly controlled by the American and Haitian governments for the purpose of developing Haitian agricultural resources) to produce rubber in Haiti for use in the American economy. The shift of manpower and resources into this type of production proved of little value, since other and cheaper sources of supply became accessible at the end of World War II. For a discussion of SHADA, see D. D. Humphrey, "Haiti," in S. E. Harris (ed.), *Economic Problems of Latin America* (New York: McGraw-Hill Book Company, Inc., 1944), Chap. XV.

economic development beyond elementary levels is to become a reality in the near future, however, additional outlays must be made, financed either domestically or from foreign sources.

4. **The Distribution of Benefits.** The question is sometimes raised as to who within the underdeveloped countries is likely to benefit from a program of economic development. It appears, on the surface at least, that most benefits which accrue are general in nature. A special question arises, however, in the case of expenditures intended to increase agricultural output. Because much of the arable land in underdeveloped countries frequently is owned by a relatively few landowners, and because actual production is ordinarily in the hands of numerous tenant farmers whose rentals constitute a substantial portion of the value of yield (e.g., 60 to 70 per cent in some Asiatic countries), it is sometimes argued that an increase in output benefits landlords as much as, or more than, it does the tenants who comprise the bulk of the population. Accordingly, some critics argue, land reforms are needed in a number of underdeveloped countries if the average standard of living is to be improved markedly.

Although the Act for International Development, which authorized the Point Four Program, speaks in terms of "increasing productivity" and "raising standards of living," it does not mention the touchy subject of land reform which conceivably may in some instances stand between the two expressed objectives. Of course, an attempt to force action in this connection may readily be construed as "political interference," and hence may not be regarded as a proper objective in a program such as Point Four.

THE COLOMBO PLAN

At meetings of the ministers of the British Commonwealth countries, held in Colombo and Sydney in early 1950, some of the economic problems of South and Southeast Asia were discussed. One problem upon which action was deemed necessary was that of economic development. The consensus of opinion was that joint action might accomplish more than unilateral action. It was thereupon decided to form a planning organization representative of the countries most directly concerned. This organization was to direct its attention at the outset to the most pressing problems and was later to formulate long-range plans for promoting economic development. Such a planning organization, the Colombo Plan for Cooperative Economic Development in South and Southeast Asia (commonly referred to simply as the "*Colombo Plan*"), was formally

initiated following meetings in London in late 1950 of delegates representing the Dominion Governments of Australia, Canada, New Zealand, India, Pakistan, and Ceylon, and of delegates of the United Kingdom representing the non-self-governing British domains of Southeast Asia.

The Colombo Plan officially commenced operation on July 1, 1951. Full participation in the Plan was limited at the outset to British Commonwealth territories, but provision was made whereby other countries in Asia were free eventually to participate in the program if they so desired. Initial members of the Colombo Plan included Ceylon, Malaya, India, North Borneo, Pakistan, Sarawak, and Singapore in South and Southeast Asia, and the United Kingdom, and the British Dominions of Canada, Australia, and New Zealand, outside the area, were other participating countries. Additional countries have since joined the Plan in a formal sense, but at present all of these are relatively unimportant in the organization. Included in the latter category of countries are Indochina, Nepal, and Burma.

Goals of the Colombo Plan

The Plan set two goals for the ensuing six-year period (July, 1951, to July, 1957):

First, the immediate goal was to increase food production sufficiently to keep pace with anticipated population growth. It was felt that even the most ambitious of developmental programs was not likely to raise the average standard of living in the immediate future. Considering the fact that the population of South and Southeast Asia, now totaling 623 million and confined to a relatively small fraction of the world's land area, is growing at the current rate of 2.2 per cent (13.5 million) per year, even maintaining the average standard of living may be regarded as an accomplishment of sorts.

Second, the long-run goal was to lay the groundwork for industrial and agricultural development which might in time serve to raise the average standard of living. It was felt that over a period of years much might be done to change the traditional pattern of subsistence farming and to provide off-the-farm work for some portion of the rural population.

In short, the Colombo Plan did not set as its goal the rapid transformation of a rural economy into an industrial economy. Rather than to embark upon hastily conceived and grandiose schemes of industrialization, which though spectacular in appearance are frequently doomed to early failure, the Plan emphasized a slow and cautious approach in improving agriculture, raising social welfare, and laying the foundations necessary for subsequent industrialization.

The scheduled operations of the Colombo Plan were, in turn, divided into two parts:

First, a special three-year program of technical assistance was initiated with a total budget of $22.4 million pledged by the United Kingdom, Australia, Canada, and New Zealand. The United States agreed to coordinate its Point Four Program of technical assistance in Asia with the aims and objectives of the Colombo Plan.

Second, the Colombo Plan proposed an expenditure of $5,230 million on economic-development projects over a six-year period. Nearly three-fourths of this amount was scheduled for use in India, one-seventh for Pakistan, and the remainder for Ceylon and the British-administered territories of Southeast Asia. Slight revisions were subsequently made to allow for relatively small expenditures in the additional countries which joined the Plan. The funds were scheduled to be spent for the following purposes: (1) 32 per cent for improvements in agriculture, (2) 10 per cent for the development of industry and mining, and (3) the remainder to create the necessary preconditions of industrialization — transport and communications (34 per cent), fuel and power (6 per cent), and public housing, health, and education (18 per cent). According to the official text of the Colombo Plan, the major targets of the six-year program were as follows: (1) an increase of 13 million acres (3½ per cent) in the land under cultivation, (2) an increase of 13 million acres (17 per cent) in the land under irrigation, (3) an increase of 6 million tons (10 per cent) in food-grain production, and (4) an increase of 1.1 million killowatts (67 per cent) in electric power generating capacity.

Financing the Colombo Plan

The Colombo Plan scheduled an expenditure of $22.4 million for technical assistance during the initial three-year period, and an expenditure of $5,230 million for economic-development projects during the entire six-year period through July, 1957. Funds for technical assistance were pledged by the United Kingdom, Australia, Canada, and New Zealand. Of the $5,230 million destined for economic-development projects, $3,884 million was scheduled to come from the internal resources of the underdeveloped participating countries themselves (almost two-thirds of this amount from government revenues and surplus, and one-third from public borrowing). It was anticipated that the remainder would be met from the following sources: (1) from funds supplied by the United Kingdom and by some of the Dominions, such as Australia, Canada, and New Zealand, (2) from private foreign investors, (3) from loans extended by

international institutions, such as the IBRD, and (4) from loans extended by non-Commonwealth governments, such as the United States.

To some extent, funds made available by the United Kingdom to the underdeveloped countries, since all the initial members, and all the more important present members (e.g., India, Pakistan, and Ceylon), are members of the sterling area, represent withdrawals from sterling balances built up by the latter countries in trade with the United Kingdom, especially during World War II. For example, the United Kingdom has been releasing sterling balances to India, Pakistan, and Ceylon in connection with the Colombo Plan at the rate of about £42 million (approximately $110 million) per year. Loans by non-sterling-area countries (e.g., Canada), too, provide a means whereby blocked sterling balances may be activated.

Political Overtones

The Colombo Plan has distinct political overtones. It is not inaccurate to refer to it as a British Empire project. All the participating countries that have been members since the outset are in the British Commonwealth. Although the Plan is sufficiently flexible to allow additional countries to enter (and several have entered), the very fact that it is designed for countries in South and Southeast Asia means that membership must continue to consist almost exclusively of British Commonwealth countries.

Possible benefits which accrue to Great Britain through the Colombo Plan include the following: First, the promotion of developmental projects tends to encourage British exports. This tends to follow from the fact that virtually all the financing is in terms of sterling-area currencies, and from the fact that Great Britain is the only country within the sterling area which has many of the types of goods required. Second, the type of developmental projects initiated tends to encourage production which either makes the countries concerned less dependent upon imports from outside the particular currency area (i.e., the sterling area in virtually all instances) or gives rise to raw materials and foodstuffs, some of which may be used to meet the import needs of Great Britain. Third, the fact that the countries of South and Southeast Asia have average per-capita incomes which are among the world's lowest makes them potentially vulnerable to "leftist" appeals. The Colombo Plan, accordingly, is part of the British Commonwealth's answer to the threat of communist encroachment in Asia.

THE "FOMENTO" CORPORATIONS

In recent years there has been great interest in Latin America in the promotion of economic development. A number of the countries have

instituted national economic plans, whereby the governments attempt to control the direction and pace of economic development. As a general rule, the national planning organizations have been intent upon the development of manufacturing, even to the point of fostering potentially uneconomic enterprises. The governments have shown considerable willingness to assist new industries, especially through the granting of tariff protection, subsidies, favorable exchange treatment, and loans.

As an aid to industrialization, several of the governments have established "*fomento*" corporations. The fomentos are government-sponsored developmental corporations engaged in organizing and financing new industries. The fomentos typically lend to private enterprises, but in some cases they own and operate businesses. Funds may be obtained from local commercial banks or other domestic sources, but more often fomentos are financed with funds obtained from foreign sources, such as from the United States Export-Import Bank.

The manner in which funds frequently are raised in the domestic market tends to foster inflation. A common procedure is to raise funds through sale of bonds to banks, leading to a monetary expansion. The result then tends to be inflation and "forced saving," the nature of which we have discussed earlier.

Foreign funds are frequently obtained on a "package-loan" basis, i.e., a lump sum is borrowed for the general purpose of "development," but the specific projects to be financed are determined later by domestic authorities. This procedure makes it possible for a country to employ foreign capital while at the same time retaining for itself the right to determine what projects are to be financed.

The nature and scope of the activities of the fomentos may be illustrated through reference to several countries. In Argentina, the Instituto Argentino de Promoción del Intercambio (IAPI) has, as one of its many functions, the task of promoting commercial, industrial, and transport enterprises. The Central Bank, too, concerns itself with the promotion of industrialization, cooperating with or working through IAPI. In Chile, the Corporación de Fomento de la Producción plans and establishes new industries, and in some cases continues to operate them after they have been established. The Chilean steel industry, for example, is a product of Corporación de Fomento. Similarly, in Colombia, the Instituto de Fomento Industrial is concerned with the promotion of basic industries, while the Instituto de Fomento y Producción in Venezuela has much the same function.

The fomentos are frequently criticized on two major scores. First,

when fomentos establish enterprises on their own accord, they tend not to relinquish their control at a later date. This is usually at variance with the intent expressed in the legislation under terms of which the fomentos act. The theory is that a fomento is to begin a business enterprise, but that it is to give up operation and control (except in rare instances) once the enterprise is flourishing. In practice, however, enterprises so established tend to remain in the hands of the fomento indefinitely. Various possible reasons may be cited for this situation: private investors are not financially able to purchase the enterprises; the enterprises require special government assistance (e.g., special tax or exchange treatment, or subsidies) in order to continue in operation; and dominant personalities in the government are not eager to relinquish control over government-fostered business enterprises.

Second, and more important, the fomentos tend to support uneconomic enterprises on numerous occasions; specifically, loans of doubtful merit are sometimes made to private entrepreneurs. This situation arises, not because the fomento-type organization is inherently conducive to such practices, but because the type of environment within which the fomentos have to operate tends to encourage unsound investment practices. In Latin America it is typical to find that a relatively small and closely knit "upper-crust" has a rather firm grip both on the more important facets of economic activity and on the more important political offices. "Big business" and "politics" are inseparable in the typical Latin-American country. The result of this environment, of course, is that *any* government lending agency readily becomes a vehicle for financing the pet projects of special-interest groups. The criticism is basically of the general environment; what is said of the fomentos in connection with the general environment might be said also of any governmental financial institution in the countries concerned.

All factors considered, however, the fomentos appear to have assisted in the process of economic development in the countries in which they exist. Specific projects, some of them large-scale enterprises, have arisen as a direct result of financing through fomentos. In numerous instances, the enterprises would not have arisen except for the financial assistance rendered in this manner, and in other instances the inception of the enterprises would otherwise likely have been long delayed.

THE INTERNATIONAL BASIC ECONOMY CORPORATION

The International Basic Economy Corporation (IBEC) is a privately-financed, profit-making enterprise which has undertaken the task of im-

proving primary production and the distribution of goods in Latin America. The originator of the idea behind IBEC was Nelson A. Rockefeller, Coordinator of Inter-American Affairs during World War II, who long had been impressed with the relative backwardness of production and marketing in some of the underdeveloped countries of Latin America.

IBEC was incorporated as a Rockefeller family enterprise under the laws of New York State in January, 1947. Its founders felt that basic developmental projects which would improve the average standard of living in the underdeveloped countries could be successfully undertaken by private investors seeking profit. IBEC, accordingly, was an attempt to show United States and Latin-American businessmen how a group of well-run businesses in Latin America could benefit both the economies and the businessmen themselves. It was hoped that local investors could be induced to participate in such undertakings, resulting in joint operation. It was further planned that once a project had been in operation for about a decade, IBEC would (in some instances) step out, leaving ownership and operation to local groups. The aim has been to train local personnel in anticipation of the day when domestic interests would assume complete responsibility for continued operation. The procedure of IBEC, in short, has been to set up "pilot projects" which demonstrate what can be done, while at the same time allowing for eventual domestic ownership and operation of the projects. IBEC, in a sense, is a private Point Four program.

IBEC's initial capitalization totaled $5 million, but the corporation was soon joined by petroleum companies, fomento corporations, and by other local groups, so that today it holds over $20 million in capital. IBEC began operations in Venezuela and Brazil, and later undertook projects in Ecuador also. All the projects undertaken have been concerned with the production and distribution of agricultural and livestock products; IBEC has operated no industrial enterprises.

Specific IBEC projects include a fishing enterprise, experimental farms (including vegetable and rice production and the production of hybrid seed corn), livestock breeding, milk distribution, wholesale and retail distribution of other food products (to provide consumers with a greater variety of goods and at lower prices), provision of facilities for the bulk handling of grain (to reduce the cost involved in handling individual sacks), provision of mechanized agricultural services available to farmers on a fee basis, and provision of a helicopter service for dusting field crops with insecticides.

IBEC has been criticized on two major scores, especially in Latin

America itself. First, the criticism is frequently heard that IBEC has not lived up to its avowed objective of eventually turning enterprises over to local entrepreneurs. This charge is difficult to evaluate since the period of IBEC's operation is relatively brief. The full story on this score is not yet revealed.

A second criticism, quite different in nature from the first, states that IBEC is "unbusinesslike" in its attitudes. Some persons regard it as unthinkable that IBEC can demonstrate the economic feasibility of particular private enterprises in Latin America when it at the same time speaks in terms of eventually relinquishing ownership of its enterprises. The basic motivation of private enterprise is profit, and if profit is being made it is (perhaps) unreasonable to expect the owners to pursue a deliberate policy of voluntarily stepping aside at some future date. These critics feel that the latter policy smacks of philanthropy, and that it certainly is at variance with the basic motivation of private enterprise — the maximization of private profits. In short, IBEC, so it is alleged, has a motivation somewhat different from that of other businessmen operating in the Latin-American environment. If the charge has any basis in fact, it throws serious question upon IBEC's avowed objective of setting standards for other private entrepreneurs.

THE PROPOSED INTERNATIONAL FINANCE CORPORATION

The United States International Development Advisory Board, in a report published in March, 1951, recommended that an International Finance Corporation (IFC) be created as an affiliate of the IBRD in order to render services not within the scope of the latter as then constituted.

Specifically, the IFC was proposed to supplement the IBRD in two major respects. First, the IFC was to be authorized to make loans to private enterprise without governmental guarantee. While the IBRD is empowered to lend to private borrowers, such loans must be guaranteed by the government (or by the central bank, or its equivalent) of the country in which the project to be financed is located. This requirement, as we have previously observed, has on occasion deterred private borrowers from using the facilities of the IBRD, since a governmental guarantee may invite official interference in the conduct of the business. Governments, too, have hesitated to guarantee private loans, since in so doing they may throw themselves open to the charge of favoritism.

Second, the IFC was to be authorized to make equity investments in participation with private investors. (Equity investments are of the portfolio type; the lender acquires stocks and bonds, but — in the case of

stocks — generally holds less than a controlling fraction of the outstanding issue.) The IBRD was never authorized to engage in equity financing; in fact, the Bank has had to abandon consideration of some projects in the past because the prospective borrowers were unable to raise elsewhere the equity capital required for operation.

It was proposed that the capital of the IFC be obtained through subscription by member governments and not from the IBRD. Proponents of the IFC maintained that only a relatively low amount of capital would be needed to carry the volume of business likely to occur. The argument was that the IFC could sell securities from its portfolio, thereby creating a "revolving fund" for equity financing. Of course, it is reasonable to assume that the salability of securities would have depended, probably in high degree, upon the guarantees of the IFC. Few countries were willing to assume responsibility for the activities of an institution committed to large-scale financing on this basis. The latter point provided a major criticism of the proposed IFC, and served to dampen enthusiasm for the institution. In any event, no conclusive action, either pro or con, was taken on the IFC by 1954.

THE PROPOSAL FOR "SUNFED"

During 1953 a group of seventeen small underdeveloped countries submitted a proposal to the United Nations, requesting that organization to consider the establishment of a Special United Nations Fund for Economic Development (SUNFED). A capitalization of $250 million was proposed.

This proposal reflects the desire of the underdeveloped countries for action in the field of economic development. The countries frequently cannot qualify for foreign capital on the terms it is offered; or, conversely, the countries frequently desire to borrow for purposes and on terms which do not appeal to the present prospective lenders. Consequently, to the underdeveloped countries there appears to be a case for an additional lending agency, one which can cater to their specific needs.

The specific purposes of SUNFED, as outlined, were two-fold. First, it was to make available grants-in-aid, under certain conditions, to the underdeveloped countries. Second, it was to finance loans on a low-interest and long-term basis for non-self-liquidating projects in the underdeveloped countries. To many, the types of lending proposed appeared highly "unbusinesslike." In any event, no conclusive action, either pro or con, was taken on SUNFED by 1954.

SUMMARY

In addition to the International Bank, a number of other institutions and programs have been initiated or proposed during recent years, all of which have been important in the promotion of economic development. The Export-Import Bank in the United States, begun in 1934, makes three main types of loans: (*a*) loans to United States exporters, (*b*) general loans to foreign governments, and (*c*) project loans to foreign borrowers. The Point Four Program, put into operation in 1950, is intended to encourage economic development in the underdeveloped countries through the rendering of technical assistance by the United States. The Colombo Plan, put into operation in 1951 by the British Commonwealth countries, is designed to aid the underdeveloped countries of South and Southeast Asia. The Colombo Plan combines technical assistance with the promotion of specific economic-development projects in the participating countries. In Latin America, so-called fomento corporations are widely relied upon to furnish credit to new or growing enterprises. The International Basic Economy Corporation, operating in several countries in Latin America, also has as its objective the promotion of economic development. Its efforts are significant mainly because the organization is privately financed and managed.

Recent proposals include the following: (1) In 1951, an International Finance Corporation was proposed as an affiliate of the IBRD in order to render particular services not within the scope of the latter institution as presently constituted. Specifically, it was proposed that such an affiliate be established (*a*) to undertake loans to private borrowers without governmental guarantee, and (*b*) to make equity investments in participation with private investors. (2) In 1953, a group of seventeen small underdeveloped countries proposed that the United Nations establish a Special United Nations Fund for Economic Development. It was proposed that the institution finance grants-in-aid and low-interest, long-term loans for non-self-liquidating projects in underdeveloped countries. Neither proposal has as yet been accepted, nor conclusively rejected.

SELECTED REFERENCES

Export-Import Bank, *Reports,* Washington, semiannual.

International Development Advisory Board, *Partners in Progress: A Report to the President,* Washington, 1951.

"Nelson Rockefeller's IBEC," *Fortune,* February, 1950.

The Colombo Plan for Cooperative Economic Development in South and South-East Asia. London: His Majesty's Stationery Office, 1950.

U. S. Department of State, *Point Four,* Washington, 1950.

20

The International Monetary Fund

As PREVIOUSLY STATED, the Bretton Woods Conference of 1944 led to the formation of two new international organizations. The first, the IBRD, was to operate in the field of international investment, while the second, the International Monetary Fund (the IMF, or the Fund) was to concern itself with monetary and exchange-rate matters. This chapter treats the origins, purposes, and operation of the IMF.

ORIGIN OF THE FUND

The interwar period (the years between World War I and World War II) was characterized by hectic experiences in the international monetary field. Of basic significance, the international gold standard had given way to a system of independent national currencies. While the international gold standard had lost favor because of its rigidity and its tendency to subordinate the domestic economy to international forces, the independent currency systems which followed soon gave evidence of having their own shortcomings. The existence of flexible exchange rates tended to create uncertainties for trade, to foster capital flights, and to induce competitive exchange-rate depreciation (i.e., the existence of flexible exchange rates gave rise to a race between countries in which each attempted to depreci-

ate by an amount sufficiently great to gain a relative trading advantage vis-à-vis the others). Attempts by individual countries to stabilize their exchange rates through the imposition of exchange controls also proved far from perfect. As exchange controls came to be widespread, multilateralism in trade gave way to bilateralism, the effect of which in turn was to channel trade along less economic avenues.

Economists and statesmen were in fairly general agreement that the chaotic currency conditions of the interwar period, and especially of the 1930's, were at variance with the promotion of a healthy international economy. The possible repetition (or perhaps intensification) of these experiences during the post-World War II years was not a pleasant prospect. It was only natural, therefore, that thought was given to ways and means whereby such an occurrence might be prevented. Already by 1943 two rival proposals, the British "Keynes Plan" and the American "White Plan," had made their appearance. While the two plans differed in some important organizational and operational respects,[1] they were similar in that they both stressed the desirability of maintaining relative exchange stability, provided this goal might be achieved without actually restoring the international gold standard and without precluding individual countries from retaining a high degree of independence in the formulation and conduct of their domestic monetary and fiscal policies.

In an attempt to reconcile differences between the American and British proposals, representatives of the two countries held a series of meetings in Washington in early 1944, during which period representatives of some twenty other countries were also consulted. By April, 1944, a preliminary agreement (the "Joint Statement by Experts on the Establishment of an International Monetary Fund") was reached. This agreement

[1] The British "Keynes Plan," named after Lord Keynes, proposed an International Clearing Union. It was proposed that member countries experiencing deficits in their balances of payments be permitted to draw upon the resources of the Clearing Union. (In essence, this is the overdraft principle common to banking in Great Britain and in numerous other countries; under it, an authorized party receives a line of credit which allows it to make withdrawals in excess of amounts actually contributed.) On the other hand, it was proposed that a country having a credit balance on current international account be given credit with the Clearing Union as payment for its "surplus" foreign sales, this credit to be freely transferable in payment of international obligations, but cancelable if not used before the lapse of a stipulated time period. The latter provision was in keeping with the notion that a creditor country should be encouraged to increase its foreign purchases, but failing to do so it should bear the major burden in the adjustment of international accounts.

The United States developed the "White Plan," named after Harry D. White of the Treasury Department. This plan proposed the establishment of an International Stabilization Fund, financed through contributory payments by members in accordance with prescribed quotas. Under it, members were to have access to the pooled resources under certain conditions when needed to tide them over short-term balance-of-payments difficulties.

served as the basis for discussion at the Bretton Woods Conference, held in July of 1944, and its major provisions were carried over into the final Bretton Woods Agreement. Following acceptance of the latter agreement by the required number of countries (the United States Congress gave its approval in July, 1945), the IMF (and the IBRD) came into formal existence in December, 1945.

PURPOSES OF THE FUND

The IMF was intended to promote more orderly conduct in the international monetary field, and thereby to prevent a repetition in the post-World War II years of the chaotic currency and exchange-rate conditions which had characterized the interwar years. According to the Articles of Agreement, its purposes included the following:

(1) to promote consultation on international monetary problems;
(2) to facilitate the expansion and balanced growth of international trade, and thereby to promote and maintain a high level of employment and income;
(3) to promote exchange stability and orderly exchange arrangments, and to avoid competitive exchange depreciation;
(4) to help re-establish a multilateral system of payments and to eliminate foreign exchange restrictions which hamper world trade;
(5) to provide means whereby a country may correct maladjustments in its balance of payments without resorting to measures destructive of national or international prosperity;
(6) to promote measures which shorten the duration and lessen the severity of balance-of-payments disequilibria.

In concise fashion, the Fund was organized to perform three major tasks: (1) The Fund was to assist in the determination of the initial par value of currencies following World War II. (2) The Fund was to assist in the maintenance of these rates (in a free exchange market) by rendering short-term assistance to tide countries over temporary balance-of-payments difficulties. (3) In event of chronic difficulties arising in a member's balance of payments, the Fund was to provide the machinery through which an orderly change in the member's rate of exchange might be undertaken without such action leading to a wave of competitive exchange-rate depreciation. In other words, the Fund aimed to promote relative exchange-rate stability, but nevertheless recognized the need for some degree of flexibility (actually "internationally controlled flexibility") in exchange rates. The rationale and mechanics of the Fund's procedure are discussed below.

FINANCES AND ORGANIZATION

Any country may become a member of the Fund by subscribing to the Articles of Agreement. From a membership of forty-four countries at the outset, the Fund has grown to include fifty-six countries (June 30, 1954). Important member countries include the United States, Great Britain, and France. Important countries which do not belong include Argentina, Switzerland, and the U.S.S.R.

The Fund actually consists of a pool of gold and national currencies totaling $8,845.5 million in value (June 30, 1954), contributed by members according to "quotas" based upon each country's importance as measured by its foreign trade, national income, and population. The quota of the United States is $2,750 million, while that of Great Britain is $1,300 million, and others are correspondingly less. Each member contributes to the Fund (1) 25 per cent of its quota in gold (or 10 per cent of its holdings of gold and United States dollars, if this amount is less) and (2) 75 per cent of its quota in its own national currency. The size of the individual quota is important because it determines not only a member's contribution, but also the amount of short-term help a member may receive from the Fund in event of balance-of-payments difficulties.

Each member has a voting strength of 250 votes plus an additional vote for each $100,000 of quota. Provision is also made for members to receive additional votes if other members make use of their currencies through the Fund, while members lose votes in proportion to their use of the Fund's resources. The United States has gained votes — one additional vote for each $400,000 of its currency (net) used by other members — because it is not using the Fund's resources, whereas other members have purchased United States dollars from the Fund. The United States holds some 29 per cent of the total voting strength, while Great Britain holds roughly 14 per cent of the total votes.

Management of the Fund is topped by a Board of Governors, consisting of one governor for each member country. The Board meets annually in Washington and deals with matters of basic policy. Day-to-day business is handled by a body of sixteen Executive Directors, five of whom individually represent each of the five largest member countries. Below them is a staff recruited from the member countries.

DETERMINATION OF INITIAL PAR VALUES

Of the three major tasks with which the Fund was to concern itself, the first one to arise involved the fixing of the initial par values of the

currencies of members. The determination of workable parities was not an easy task at the time, since world trade had been seriously disrupted and much productive capacity had been destroyed during World War II, and since the member countries had been subjected to varying degrees of inflation.

Two alternatives were open: (1) the Fund could attempt to arrive at exchange rates which would probably produce equilibria in the balances of payments of individual countries in the long run, a virtually impossible assignment; or (2) the Fund could largely accept the exchange rates then in existence, with the understanding that these would be subject to change in the future if conditions warranted. Of the alternatives, the second was chosen. It was generally acknowledged at the time that these rates were not necessarily equilibrium rates, and that in all probability numerous adjustments would be required in the future. In event of adjustments, these were scheduled to occur in accordance with the normal procedure of the Fund (discussed below).

SHORT-TERM BALANCE-OF-PAYMENTS DIFFICULTIES

A second major task of the Fund (indeed, *the* major task) was to help members to maintain their rates of exchange at fixed levels. It was felt that if a member was to be confronted by a *temporary* deficit in its balance of payments, it was better to render assistance to tide the member over its difficulties than to offer the member no alternative but to succumb under pressure either to a depreciation of its exchange rate or to the imposition of exchange control.

An example may serve to illustrate the nature of the problem. Let us assume that a one-crop country is confronted with a crop failure, the effect of which is to reduce its exports during a one- or two-year period (and, hence, its international receipts as well). In consequence, the country experiences a deficit in its balance of payments. Given no other choice, the country may attempt to equilibrate its international accounts either through resort to exchange depreciation or through the imposition of exchange control. Either course of action, however, appears unduly drastic in view of the fact that the deficit is presumably of a temporary, or short-run, nature (i.e., the situation which gave rise to the deficit is not likely to last beyond the one- or two-year period). But if the exchange rate is to be maintained at the prevailing level, short of exchange control, the country must be prepared to bolster in some manner its dwindling reserves of foreign exchange. What the country needs is access to some amount of foreign exchange which it cannot earn for itself at the moment.

It is temporary assistance of this type which the Fund was specifically designed to offer.

Under the arrangements established by the Fund, when a member requires a particular currency to make current international payments (i.e., the member's earnings and reserves of the currency are inadequate to meet current demands), it may borrow that currency from the Fund simply by making additional deposits in its own currency. The member ordinarily has no shortage of domestic currency; the Fund simply provides the machinery through which the member may "trade" its own currency for the foreign currency which it needs but does not have, i.e., which it has been unable to earn for itself in view of its particular temporary difficulties. In this way, short-run pressures upon a member's exchange rate need not give way to either exchange depreciation or exchange control, neither of which would presumably be warranted on the basis of long-run considerations, but which, if permitted to occur under temporary stress, would tend on occasion to invite retaliatory action on the part of other countries.

There is a limit, however, to the amount of assistance a member may receive. Purchases of foreign currencies during a given year may not exceed 25 per cent of a member's quota, nor may total purchases exceed 125 per cent of a member's quota (except in rare instances when the Executive Directors may agree to waive the quota limitations). In other words, maximum currency purchases continued over a five-year period normally exhaust a member's line of credit. For example, if Country A has a quota of $100 million, it pays into the Fund $25 million in gold (or 10 per cent of its holdings of gold and United States dollars, if this amount is smaller) and $75 million in its own currency, say pesos. The country may later require foreign currency, say United States dollars, to balance its current international accounts. In such case, the country may in the first year purchase up to 25 million in dollars simply by turning over to the Fund an equivalent value in pesos. The country may continue at this pace for four additional years, at which time its purchasing privileges are at an end. In our example, at the close of the five-year period the Fund holds $200 million in A's currency (the subscribed quota of $75 million plus $125 million paid in the purchase of dollars), and the Fund's holdings of dollars are diminished by $125 million. The presumption is, however, that well before the lapse of the full five-year period either the short-term difficulties will have ended or the difficulties will have been recognized as long-run in nature (and hence eligible to be dealt with through another procedure, discussed below).

Though the Fund in the foregoing example sells United States dollars, the sale in reality comprises a loan from the United States to Country A. Because it is a loan, an interest charge is levied upon the borrower (or buyer). The schedule of rates varies from 0 to 5 per cent, depending upon the amount borrowed (purchased) and the length of time outstanding. The interest charge is intended to discourage excessive or prolonged use of the Fund's resources. There also is a uniform service charge of ½ of 1 per cent on all currency purchases.

Also, because the Fund's sale of currency is tantamount to a loan, a member using the Fund's resources is under some obligation to repay. A member who has purchased (borrowed) currency from the Fund need not repay (i.e., repurchase its currency), however, unless its holdings of gold and convertible currencies increase during subsequent years. Actually, a member has an incentive to repurchase in rapid fashion in order to avoid the higher interest charges which accompany loans of longer duration. The Fund itself is powerless to compel such repurchases, however, other than to request the member to repurchase its currency once the interest charge has reached 4 per cent.[2] If the member does not comply, the most the Fund can do is to refuse to extend further aid to the member.[3]

The Role of Exchange Control

A fundamental objective of the Fund thus was to promote stable exchange rates in a world free of exchange controls. Despite its emphasis upon the desirability of achieving an early restoration of free, multilateral trade, the Fund was compelled at the outset to recognize that existing controls were not likely to be eliminated overnight. Rather, the Articles of Agreement and the Fund's officials spoke in terms of a *transition,* preferably a rapid transition, to an international payments system free of exchange restrictions.

Special provision was made in the Articles of Agreement in order to speed the removal of exchange restrictions. Specifically, five years after the beginning of exchange operations (i.e., beginning in 1952), and in each year thereafter, members still retaining exchange controls were to consult with the Fund regarding the removal of such restrictions. This provision reflected the then-current belief that the transition to a "normal" world would require little more than five years at the outside. If a member persisted in retaining exchange control when such was deemed no longer

[2] Art. V. 8d.
[3] Art. XIV. 4.

necessary, the Fund was empowered to deny the member the use of its resources.

Even if existing exchange restrictions were successfully eliminated, the Fund recognized that under certain conditions exchange controls might still be needed, and even prove desirable. Specifically, the Fund recognized the need for exchange controls under two possible sets of conditions: (1) as a necessary rationing device in the case of "scarce" currencies, and (2) as a method for controlling capital movements. (These permissible exceptions are discussed below.) In short, *the Fund was inclined to regard exchange control as an appropriate policy under particular circumstances, but not as one to be continued indefinitely.*

1. **Scarce Currencies.** It was envisaged from the start that of the currencies held by the Fund, the greatest demand was likely to be for United States dollars. Because the Fund's supply of dollars was limited (about $2 billion, plus about $1.5 billion in gold which could be used to obtain dollars, or a total of about $3.5 billion), there was some danger that under certain circumstances the Fund might run short of dollars. The possibility of an eventual dollar shortage in the Fund (or the possible shortage of any currency) led to the adoption of special provisions concerning the treatment of such "scarce" currencies.

It was provided that if a particular currency became scarce in the Fund, the organization was to be free either (*a*) to purchase additional supplies of that currency,[4] or (*b*) to declare such a currency to be scarce and then proceed to "apportion its existing and accruing supply of the scarce currency with due regard to the relative needs of members, the general economic situation, and any other pertinent consideration."[5] Concurrent with such a declaration, the Fund was to issue a report concerning its actions. Issuance of a declaration was to constitute an authorization for any member, after consultation with the Fund, to impose exchange control (on a temporary basis) over the use of the scarce currency.[6] Such authorization was to expire upon the Fund's declaration that the currency in question was no longer scarce.

The scarce-currency provision was designed especially to placate those members who feared the possible international impact of the domestic policies, or lack thereof, of the United States. Specifically, at the time of the Bretton Woods Conference there was widespread doubt that the United States would succeed in maintaining a stable economy during the

[4] Art. VII. 2.
[5] Art. VII. 3a.
[6] Art. VII. 3b.

post-World War II years, a matter of grave concern in many countries because of the "key" position of the United States in the world economy. Since a depression in the United States would entail a reduced volume of imports from the rest of the world, the world's dollar earnings would decline, forcing some countries to purchase dollars from the Fund in order to pay for needed goods and services obtained in the United States. Such dollar purchases from the Fund would be limited to about $1.5 billion per year (quotas of members other than the United States total about $6 billion, only 25 per cent of which may ordinarily be drawn upon in any single year). Since the Fund's assured supply of dollars was limited to about $3.5 billion, this would mean that its dollar holdings could conceivably be exhausted over, say, a three-year period, whereas a depression might run for a somewhat longer period. Moreover, there was reason to believe that during a serious depression the aggregate balance-of-payments deficit of the rest of the world vis-à-vis the United States would exceed $1.5 billion per year. Maximum use by members of their borrowing privileges would then provide them with dollar resources short of their minimum needs. Under the circumstances, members were unwilling to agree to remove exchange restrictions unless given certain assurances. The major assurance provided was in the form of the scarce-currency provision which, when invoked, served to "legalize" exchange controls on the part of particular countries.

2. **Capital Movements.** Exchange control was also held to be a permissible practice when employed to prevent particular capital movements (whether or not the latter involved a currency declared scarce). In the wording of the Articles of Agreement: "A member may not make net use of the Fund's resources to meet a large or sustained outflow of capital, and the Fund may request a member to exercise controls to prevent such use of the resources of the Fund."[7] It was further provided that exchange control might not be exercised "in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments."[8]

In other words, members were given no license under terms of the Articles of Agreement to use exchange controls to regulate ordinary capital movements, either long-term or short-term. The Fund's provisions merely sanctioned control over "large" or "sustained" outflows of capital which, if unregulated, tend to create balance-of-payments difficulties and thereby force members to call upon the Fund for assistance.

[7] Art. VI. 1.
[8] Art. VI. 3.

LONG-TERM BALANCE-OF-PAYMENTS DIFFICULTIES

According to the theory behind the Fund, a member experiencing a short-term deficit in its balance of payments may ordinarily avail itself of the Fund's resources in order to maintain exchange stability without resort to exchange control. A member is free, in addition, to depreciate (or appreciate) by an amount up to 10 per cent without consulting the Fund. Moreover, if a member experiences an imbalance in its balance of payments, say a deficit, which is lasting and deep-seated, and which cannot be corrected either through use of the Fund's short-term lending facilities or through an alteration of the exchange rate of up to 10 per cent, the member is free to request the permission of the Fund to depreciate by a greater amount. If the Fund agrees that a member's difficulties are chronic, a depreciation of the exchange rate in excess of 10 per cent may be authorized. Such a depreciation is open only to the particular member, however, and other members are not free to follow suit (unless given approval by the Fund). In this manner the Fund makes it possible for a particular member (or conceivably members) to alter its exchange rate, thereby providing the basis which may enable it to restore equilibrium in its balance of payments, but at the same time the depreciation is prevented from becoming competitive among members.

The Articles of Agreement state that the Fund "shall concur in a proposed change . . . if it is satisfied that the change is necessary to correct a fundamental disequilibrium."[9] In other words, in determining whether to approve (or conceivably encourage) depreciation by a member, the Fund is to apply two tests: (1) Does a *fundamental disequilibrium* exist in the member's balance of payments? (2) Is depreciation *necessary* in order to correct this fundamental disequilibrium? The crucial determinant is the presence or absence of a fundamental disequilibrium.

Fundamental Disequilibrium

What is a fundamental disequilibrium? While the Articles of Agreement left the term undefined, usage served to indicate that it referred to a situation of long-run, deep-seated imbalance in a country's balance of payments, as distinct from a temporary disturbance. In the words of one writer, a fundamental disequilibrium exists when there is "a maladjustment in a country's economy so grave and persistent that the restoration or maintenance of satisfactory levels of domestic activity, employment, and incomes would prove incompatible with equilibrium in the balance of

[9] Art. IV. 5f.

payments, if not accompanied by extraordinary measures of external defense, such as a change in the exchange rates, increased tariff or exchange control protection, etc."[10]

What conditions generally give rise to a fundamental disequilibrium? A first major cause rests upon price-level distortions between countries. When one country's price structure rises more rapidly than that of others (a domestic inflation due perhaps to the pursuit of full-employment policies), its balance of payments tends to show a deficit (as imports rise and exports decline). Confronted by such a balance-of-payments disequilibrium, a country may seek a correction through the imposition of import restrictions, or through the depreciation of its exchange rate (i.e., through changing the foreign price of its money in order to bring its price structure into conformity with price structures prevailing abroad). A second major cause rests upon structural changes within individual countries or groups of countries. Such structural changes usually result from an unfavorable shift in world demand for particular export products, or from a decline in the ability of a country or group of countries to produce for export markets.

OPERATION OF THE FUND

We have observed that the Fund was established to perform three major functions: (1) to fix the initial par values of currencies following World War II, (2) to assist members in maintaining these rates of exchange (once exchange controls are gotten rid of) by rendering short-term assistance on occasion, and (3) to supervise changes in the rates of exchange of individual countries whenever such action is forced by the presence of a fundamental disequilibrium. What has been the record of the Fund to date in respect to these functions?

1. **Determination of Initial Par Values.** Before the Fund could begin exchange operations, agreement was required between it and member countries concerning the par values of the latters' currencies. It had been generally believed that the determination of initial par values would prove to be a difficult task. The world had just emerged from a five-year war; the pattern of production and trade was distorted, and inflation, present everywhere, was especially pronounced in some countries — in short, the general conditions which prevailed were anything but "normal." Rather than to attempt to determine new par values on the basis of some formula

[10] R. Triffin, *National Central Banking and the International Economy*, Postwar Economic Studies, No. 7, Board of Governors of the Federal Reserve System, Washington, 1947, p. 77.

(e.g., through use of the purchasing-power-parity concept), however, the Fund instead accepted par values based on existing exchange rates. Such initial par values were formally assigned to the currencies of thirty-two countries in December, 1946.[11]

The decision of the Fund to accept the existing exchange rates, and thereby to give them official sanction, appeared ill-advised to many persons. Many shared the opinion that the rates, in general, were inappropriate if the ultimate objective of the Fund was to promote a high volume of trade, free of exchange restrictions. It appeared quite clear that some of the exchange rates given sanction by the Fund were at levels which grossly overvalued particular currencies. Officials of the Fund, too, were aware of this fact and recognized that some of the rates sanctioned were likely later to prove "incompatible with the maintenance of a balanced international payments position at a high level of domestic economic activity."[12]

In defense of the Fund's acceptance of the parities communicated to it by members, two basic points may be cited. First, the problems confronting trade at the time were of such magnitude that a slight upward or downward revision in a particular exchange rate was likely to prove of secondary importance as compared to other current factors. Thus, officials of the Fund were of the opinion that exports of members were "limited mainly by difficulties of production or transport," and that deficits in the balances of payments of some countries were not likely to be "appreciably narrowed by changes in their currency parities."[13] Second, depreciation was largely ruled out at the time because of the likelihood that, if allowed or forced, it would have served to aggravate the problem of inflation in a number of countries.

2. Short-term Assistance. Beginning in March, 1947, the Fund stood ready to enter into exchange transactions with members confronted by short-term difficulties in their balances of payments. Between that date and the end of June, 1954, the Fund sold $1,148.9 million of currency to twenty-nine of its members. Sales consisted largely of United States dollars; relatively small amounts of Belgian francs, British pounds, and Deutsche marks were also sold. Repurchases of currencies totaled $457.6

[11] Members whose territories had been occupied by the enemy during the war were not required to communicate par values to the Fund until a later specified date. Several members availed themselves of this provision. Par values for the currencies of these countries were established, in most instances, during the subsequent year.

[12] See IMF, *Annual Report, 1947* ("Statement Concerning Initial Par Values," Appendix), Washington, 1947.

[13] *Ibid.*

million. The greater portion of the Fund's currency sales occurred during the years 1947, 1948, and 1953. Total purchases by members amounted to \$468, \$208, and \$229 million, respectively, during these years. During 1949, purchases only slightly exceeded \$100 million, and during the years 1950-52 repurchases of currencies previously sold more than offset new sales.

Considering the magnitude and duration of the balance-of-payments deficits characteristic of the postwar years, the volume of exchange transactions financed by the Fund may appear surprisingly small. We may cite three basic reasons why the volume of exchange transactions was not greater.

First, the officials of the Fund exercised restraint in making resources available to members. The original intent was that any member experiencing a temporary balance-of-payments deficit was to have access to the Fund's resources on an *automatic* basis (except in so far as prohibited by specific rules and limitations expressed in the Articles of Agreement). Shortly after beginning operations, however, officials of the Fund adopted the practice of subjecting the drawing rights of members to close *supervision*. Sales of currency were henceforth made only after examination by the Executive Directors of the circumstances leading to the request for assistance and after a favorable decision regarding the prospective ability of the member to overcome its payments difficulties within a relatively short period. The change in policy was motivated in large part by the realization that the exercise on an automatic basis by members of their drawing rights, considering the intense demand at the time for particular currencies (e.g., of United States dollars), might soon result in the exhaustion of the Fund's resources (i.e., of particular currencies and gold). On the other hand, the exercise of close control over access to resources in numerous instances left members little choice but to retain indefinitely their exchange restrictions.

Second, the willingness of the United States to extend large-scale dollar aid to various countries on a direct basis served to take pressure off the Fund. For example, the persistence of large balance-of-payments deficits in Western Europe (especially of dollar deficits), among other factors, led the United States to inaugurate the Marshall Plan, through which multi-billions in dollar aid were extended during the years 1948-51. Since countries participating in the Marshall Plan could presumably meet their minimum dollar requirements from the proceeds of United States loans and grants, the Fund adopted the view that such countries "should request the purchase of United States dollars from the Fund only in exceptional

or unforeseen circumstances."[14] The impact of the Marshall Plan upon the Fund's exchange activities is evidenced by the relatively low volume of currency sales during the years 1949-52, the approximate period of the Marshall Plan's existence.

Third, the fact that balance-of-payments deficits were both large and persistent during the postwar years served, paradoxically, to limit the use made of the Fund's resources. The Fund's resources were to be made available to countries whenever they experienced *temporary* deficits in their balances of payments. The relatively heavy use made of the Fund's resources during 1947 and 1948 in large degree reflected the belief of countries, and of the Fund's officials, that the difficulties were short-run in nature. By 1949, or thereabouts, however, what had appeared to be temporary difficulties began to be viewed as long-run difficulties. According to the theory behind the Fund, long-run deficits were to be dealt with through exchange depreciation, not through a continuation of currency purchases from the Fund. In addition, the persistence of balance-of-payments deficits during the postwar years served to prolong the use of exchange controls, which in themselves had the effect of restricting the demand for particular currencies to an amount somewhat below that likely to prevail under other circumstances.

Finally, actual or potential use of the Fund's resources, it was hoped, would assist members in lifting their exchange controls, and once lifted, would allow the members to conduct their trade on a multilateral basis, free of the encumbrances of currency restrictions. Despite its activities, however, the Fund had not yet in 1954, after eight years of operation, achieved the objective of stable exchange rates under *free-market* conditions. A majority of the Fund's members continued to enforce exchange restrictions. (Reasons for the continued reliance upon exchange controls are discussed below.)

3. **Exchange-rate Adjustments.** The Fund's record as respects the "controlled flexibility" of exchange rates under the pressure of a fundamental disequilibrium is limited to two major cases. The first case involves the *unauthorized* devaluation of the French franc in 1948, while the second involves the *authorized* devaluation of the British pound sterling (and of some other currencies) in 1949.[15]

In France, a growing inflation during the immediate post-World War II years was paralleled by a serious deterioration in the international financial position of the country. As the price level rose (relative to the

[14] IMF, *Annual Report, 1948,* Washington, 1948, pp. 48-49.

[15] Additional cases exist, e.g., Chile, Colombia, Mexico, and Paraguay.

price levels of competitive countries), exports declined and holdings of gold and foreign exchange fell to a precariously low level, despite the existence of a strict exchange-control system. The country, therefore, sought to devalue its currency, and sought, in addition, to introduce a discriminatory multiple exchange rate system. The latter proposal was intended to clear the way for the adoption of special exchange rates which would encourage exports to and discourage imports from the dollar area. While the Fund did not oppose devaluation as such, it did oppose the introduction of a discriminatory multiple exchange rate system on grounds that such action would produce needless trade distortions and would invite other countries to retaliate in kind. Despite official disapproval by the Fund, France nevertheless proceeded with the proposed devaluation (in January, 1948). The Fund promptly declared France guilty of an unauthorized change in the value of her currency,[16] thereby making her ineligible to draw upon the Fund's resources.

In consequence of the devaluation, the official rate of the French franc (applicable to all soft-currency earnings and to about one-half of all hard-currency earnings) was changed from 119.107 to 214.392 francs per dollar, a devaluation of about 44 per cent, while the free rate (applicable to about one-half of all hard-currency earnings) rapidly rose to a level of 311 francs per dollar and was eventually stabilized at 305-306 francs per dollar, a devaluation of about 61 per cent. The devaluation produced two major effects. First, exports to the United States were encouraged (and imports from the United States were discouraged). To the extent that dollar earnings were convertible at the free rate, French exporters were able to earn more francs by selling in the United States market than in, say, the British market, where a less favorable exchange rate obtained. Almost immediately the charge was widely voiced that France was attempting to solve her dollar shortage through the unsavory expedient of unfairly displacing other countries in the dollar-area markets. Second, devaluation brought with it the phenomenon of disorderly cross rates, the presence of which, for example, enabled buyers in the United States to obtain British goods more cheaply by buying them through France than by buying them directly from Great Britain.[17] The result was that Great Britain and numerous other countries lost potential dollar earnings to

[16] Under Art. VII. 3.

[17] The nature of such transactions may be briefly illustrated. Let us assume that £ 1 = \$4.00, £ 1 = 800 francs, and \$1.00 = 250 francs. (For the sake of simplicity, let us also assume the absence of transport costs.) An article priced at £ 1 then costs an American \$4.00 if purchased directly. A French trader, however, can acquire the article for 800 francs, sell it in the United States for, say, \$3.50 (saving the American purchaser \$0.50), and convert the dollar receipts into 875 francs, giving him a profit of 75 francs.

France; actually, they were put in the position of earning French francs instead of dollars.

There is some question, however, as to how effective the discriminatory devaluation proved in the solution of France's international-payments problems. It is significant that France soon (in October, 1948) abandoned her discriminatory exchange practices in favor of a uniform devalued rate. Some months later (in September, 1949) the franc, along with a number of other currencies, was again devalued, the new rate being fixed at 350 francs per dollar.

The major devaluation since the Fund's origin involved the British pound sterling, along with the currencies of twenty-eight other non-dollar-area countries and territories. Unlike the French devaluation, the British action (and related actions) had the full approval and endorsement of the Fund.

According to an IMF report presented to the Board of Governors in 1948, a fundamental disequilibrium existed in the balance of payments of Great Britain (and of numerous other non-dollar-area countries). The report attributed this situation to an increase in prices within the non-dollar area more rapid than that registered in the dollar area, thereby producing a trade imbalance and a continuing dollar shortage for the former. The report added that the discrepancy in price levels was too great to be dealt with through deflationary measures alone, although the potency of this method of correction was noted.

Following discussions between British, Canadian, and American officials, the British pound sterling was devalued on September 18, 1949, from £1=$4.03 to £1=$2.80, a devaluation of 30.5 per cent. The British devaluation was the forerunner of a wave of devaluations during succeeding days, bringing to twenty-nine the total of countries and territories devaluing, most of them about 30 per cent in terms of the United States dollar.[18] The countries devaluing were responsible for about 65 per cent of total world trade as measured by 1948 world imports; thus, in rough terms, two-thirds of the world had with one fell swoop altered its price structure relative to the remaining one-third of the world.

Following this action, the pattern of international payments shifted in the direction of greater balance. It is possible, of course, that other factors too, such as improvements in industrial and agricultural output in the devaluing countries, contributed to an improvement in their balance-of-payments positions. It is significant, however, that corrections in the

[18] For a list of countries devaluing, along with the amounts of devaluation, see Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*, Washington, November, 1949, p. 1329.

balance-of-payments positions of the devaluing countries, as stated by the Fund, "were largely in favor of countries which devalued most and against those which did not devalue or devalued least."[19]

APPRAISAL OF THE FUND

Two basic points of reference may serve as a basis for an evaluation of the Fund. First, some persons contend that the Fund was never needed, or that, having come into existence, it merely creates the illusion of fostering international equilibrium when in reality the achievement of the latter objective is primarily dependent upon factors outside its scope. This essentially is the "key-currency" argument, discussed below. Second, if it is assumed that the Fund may make a contribution, a number of questions may be raised as to how well the Fund has succeeded in achieving its objectives. For example, has the Fund succeeded in the removal of exchange restrictions? Or, has the Fund promoted exchange stability? These questions also are discussed below.

The "Key-Currency" Argument

According to one school of thought, general currency stability is possible only when there is stability in the "key" currencies, i.e., largely the United States dollar and the British pound sterling. The stability of these currencies depends basically upon the economic health of the respective "key" countries; in contrast, stability in the currencies of smaller or lesser countries is to a large extent an outgrowth of stability in the currencies of the major countries. Since the important consideration is what happens in a *few* countries rather than in *all* countries, it is argued that there is no need for an international organization such as the Fund. It is suggested that what is called for is close collaboration between the major countries, leaving other countries free to link their currencies to those of the major countries as best they can. For all practical purposes, this would imply the desirability of promoting a stable dollar-sterling rate, but it would allow wide latitude for other countries to tie in with the dollar or with sterling on such terms as best meet their needs.

The key-currency approach was widely discussed in the United States, both before and after the Fund's formation. The basic idea was helpful in that it focused attention upon the international role of the major economies, and upon the manner in which the pursuit of ill-advised policies in the major economies tends to produce serious international repercus-

19 IMF Press Release No. 142, August 31, 1950.

sions. In fact, the experiences of a number of countries during the post-World War II years served to demonstrate in no uncertain fashion some of the principles stressed by the proponents of the key-currency approach.

Failure to Remove Exchange Restrictions

One of the principal objectives of the Fund, according to the Articles of Agreement, was "to assist in the establishment of a multilateral system of payments . . . and in the elimination of foreign exchange restrictions which hamper the growth of world trade." The Fund, however, experienced difficulty in promoting this objective. As late as 1954, after the Fund had been in operation for eight years, most members still continued to rely upon exchange restrictions.

The continuation of exchange controls for a relatively few years after the war was not an unexpected development. After a number of years had elapsed without any marked shift to convertibility having occurred, however, some doubt began to be cast upon the role of the Fund in the eventual removal of restrictions. In general, the Fund exhibited optimism plus caution, especially after 1950, in its attitude toward convertibility. For example, in its 1951 report on the status of exchange restrictions, the Fund stated as follows:

> . . . the Fund believes that many countries are in a position to undertake substantial removal of discrimination and relaxation of non-discriminatory restrictions and to make significant progress toward convertibility.[20]

On the other hand, the Fund recognized certain impediments to the restoration of convertibility. A few of the major impediments cited by the Fund bear mention in this connection.

First, despite certain favorable developments in the overall picture (especially after 1950) which appeared to warrant a relaxation of restrictions, there remained a lingering fear in many quarters that the improvements which had occurred in the exchange positions of some members might prove short-lived. Under the circumstances, an attitude of "wait and see" developed. This attitude, perfectly logical in the absence of positive assurance that the improvements experienced were either genuine or permanent, served to delay the large-scale removal of exchange restrictions. The Fund indicated its awareness of this situation in the following language:

> Recognition must be given to the uncertainties of the present situation . . . [in] the removal or relaxation of restrictions.[21]

[20] IMF, *Second Annual Report on Exchange Restrictions,* Washington, 1951, p. 14.
[21] *Ibid.,* p. 8.

Second, the presence of exchange restrictions over a relatively long period tended to "warp" international trading relationships so that certain domestic interests later found it to their advantage to urge a policy of continued "economic isolation" upon their respective governments. The Fund pictured this situation in the following terms:

> In addition to the uncertainties affecting the future balance of payments and reserve positions of a number of countries, there are certain other, largely non-financial, impediments to achieving the purposes of the Fund. Important among such impediments is the *protectionist* aspect of restrictions which built up vested interests in protection from outside competition, interests which may seek to prevent the removal of restrictions even though they are no longer necessary for financial reasons.[22]

Third, some countries maintained that they had no alternative but to continue exchange restrictions since the United States continued to impede foreign entry into its markets. The Fund summarized this view in the following terms:

> A particular difficulty noted by several consulting countries concerns the problem of selling in the United States. These countries asserted that U. S. import policy would play a very important role in affecting the nature of their ultimate policy regarding restrictions, and that freer and more stable access to the U. S. market was of major importance in establishing dollar equilibrium, and thus in reducing discrimination. Some noted that, because of the character of the U. S. market, the development of new exports required investment, e.g., in special transportation equipment, and might involve large expenditures, such as on advertising, which would be undertaken only if there was some assurance that the market would remain open. Meanwhile, they held that import duties and other restrictions, including those applied through administrative discretion, made importers reluctant to incur the necessary preliminary costs. Additionally, some members expressed the opinion that a change in U. S. commercial policy would, in addition to permitting larger exports, facilitate countries by providing the conditions under which the investments could be serviced.[23]

Fourth, and perhaps of greatest single importance, there is considerable evidence that some members were inclined to view continued reliance upon exchange restrictions as an easy way out of their balance-of-payments difficulties. Specifically, some countries tended to regard exchange controls as more palatable than the pursuit of deflationary domestic policies. In summarizing its country-by-country investigation of this situation, the Fund stated as follows:

[22] *Ibid.*, p. 12.
[23] IMF, *Fourth Annual Report on Exchange Restrictions*, Washington, 1953, p. 9.

> Many countries indicated that anti-inflationary measures must be continued if they were to establish conditions which would enable them to get rid of restrictions. Others recognized that further efforts to curb inflation were needed. Some, however, stressed the problems which may be involved in carrying out anti-inflationary policies. It was pointed out that there were cases where more rigorous anti-inflationary measures may for the time being not be politically practicable. For example, there is the problem, noted by some countries that have already achieved some measure of success in practically eliminating inflationary pressure, that additional effort in the monetary and fiscal field might lead to a decline in employment.[24]

Notwithstanding the various factors which impeded the Fund's efforts to remove exchange restrictions, the Fund reported (in its 1953 report) that progress was being made. In the words of the Fund:

> . . . there is an increasing interest in relaxing restrictions on payments and moving toward convertibility. The improvement in the balance of payments positions of certain countries and the strengthening of monetary reserves should facilitate progress in this direction, especially if domestic efforts continue.[25]

The Fund expressed concern, however, that relaxation of restrictions might continue to be impeded "unless further attention is paid to the fundamental policies of both deficit and surplus countries which are necessary to get rid of restrictions."[26] The fundamental corrective measures especially stressed by the Fund included: (1) an application in the deficit countries of monetary and fiscal policies which tend to reduce inflationary pressures and thereby promote balance-of-payments equilibria, along with (2) the adoption in the surplus countries of more liberal import policies which tend to help the deficit countries to pursue appropriate domestic policies.[27]

In short, the Fund has pointed out numerous factors which have contributed to the delay in the removal of exchange restrictions. There is reason to believe, however, that the most basic factor accounting for the inability of the Fund to remove exchange restrictions involves the nature of the Fund itself. The plain fact is that the Fund was never designed to cope with problems of the type or magnitude of those which arose and persisted following World War II. The framers of the Articles of Agreement, meeting during the latter part of World War II, acted on the presumption that the problems of the postwar era would be much like those of the prewar

[24] *Ibid.*, p. 7.
[25] *Ibid.*, p. 27.
[26] *Ibid.*
[27] *Ibid.*, p. 29.

era. They visualized a world economy in which most countries would normally show neither deficits nor surpluses in their balances of payments on a long-run basis. Disequilibrium was pictured as a problem which might confront a *particular* country *on occasion*. Accordingly, the Fund was visualized as an organization whose purpose would be that of rendering short-term assistance (from a relatively small pool of resources) to the occasional member who might experience disequilibrium; if the disequilibrium proved persistent, exchange depreciation would likely constitute a workable method for restoring equilibrium, since only one country (or very few countries) would be directly involved. This was the spirit in terms of which the Fund was conceived.

The environment of the postwar period, however, was quite different from that which the framers of the Articles of Agreement had anticipated. Disequilibrium was not confined to one country at a time (or even to a relatively few countries), nor was it essentially short-run in nature; rather, the disequilibria of the postwar period were both *general* and *persistent*. Under the circumstances, no single country could safely move to convertibility as long as others failed to do likewise; the Fund, however, was not equipped resource-wise to support a move to convertibility by all countries acting simultaneously. This fundamentally was the dilemma which confronted the Fund during the postwar years.

Failure in the past need not necessarily preclude success in the future. Perhaps the Fund was ill-equipped for the express purpose of restoring convertibility on the part of several dozen countries. If, however, these countries did succeed in moving to convertibility, presumably through adoption of some "extraordinary" measures, the subsequent role of the Fund would perhaps conform more closely to that visualized by its framers. It is one thing to *restore* convertibility when currencies are generally inconvertible, but it is quite another matter to *maintain* convertibility once currencies are generally convertible.

The Maintenance of Stable Exchanges

Another major objective of the Fund, according to the Articles of Agreement, was "to promote exchange stability" (free of exchange controls). Actually the Fund has never been put to a clear-cut test on this score; while relative exchange stability has prevailed, exchange restrictions have also been fairly general. From the very outset, however, it was widely believed that the assignment given the Fund — the promotion of exchange stability free of exchange controls — was likely to prove difficult, considering the fact that the Fund was given no direct powers over the domestic monetary and fiscal policies of members.

Member countries are free to pursue independent and uncoordinated monetary and fiscal policies. In practice, as the Fund has recognized in its reports, some members pursue inflationary policies, others attempt to promote stability, and still others practice deflation. Under the circumstances, it is inevitable (in the absence of exchange controls) that some members, especially those practicing inflation, end up with balance-of-payments deficits. In event of a deficit, a member is free to seek the assistance of the Fund; the Fund stands ready, under certain conditions, to buy the currency of the member in order to allow the latter to offset its deficits without resorting to either exchange depreciation or exchange control. This is expecting a great deal of the Fund, especially considering the fact that there is no provision in the Articles of Agreement (short of an outright denial of the use of the Fund's resources) on the basis of which the latter may require a member to initiate measures to correct its balance-of-payments difficulties. Moreover, if the balance-of-payments deficits of a member persist and become long-run, the Articles of Agreement suggest that devaluation may be in order. Such a devaluation, however, must originate with the member; in the words of the Agreement, an alteration in the exchange rate (in excess of 10 per cent) "may be made only on the *proposal of the member* and only after consultation with the Fund."[28] Thus, according to some critics, the Fund was assigned responsibility for a task but was given insufficient power to do the job.

Sovereignty being what it is, it is unrealistic to suggest that members limit their rights to pursue independent domestic monetary and fiscal policies. While it is true that the particular policies pursued by a member may be ill-advised, both for it and for the world at large, it nevertheless does not follow that the member's actions should be altered on the basis of decisions other than its own. Under the circumstances, exchange stability is virtually impossible of attainment unless the Fund either (*a*) periodically "bails out" a member by means of currency purchases, or (*b*) allows exchange control. The alternative to the above is to allow flexible exchange rates (i.e., rates more flexible than are possible under the present operating rules of the Fund).

RESEARCH AND CONSULTATION

The Fund performs important services in the fields of research and consultation. Member countries are required to furnish information on a variety of subjects (e.g., their balances of payments, gold and foreign-

[28] Art. IV. 5b. Italics supplied.

exchange holdings, international investments, national incomes, price levels, etc.), which information is needed by the Fund in order to formulate its policies. The publication of much of the basic information so collected is of assistance to scholars and others interested in international affairs, and is of special interest to those persons wanting to undertake comparative studies involving numerous countries. In addition, the Fund's staff is responsible for the preparation of numerous special studies on topics of interest to member countries. IMF publications include a *Balance of Payments Yearbook* (annual), a report on *Exchange Restrictions* (annual), *International Financial Statistics* (monthly), *Staff Papers* (occasional), and others.

Finally, the Fund supplies technical missions to countries which seek its advice and help. The reports of such missions frequently serve as the basis for economic reforms.

SUMMARY

The International Monetary Fund is the twin organization of the International Bank (IBRD). The purposes of the Fund, according to the Articles of Agreement, are (1) to promote international monetary cooperation and consultation, (2) to facilitate the expansion and balanced growth of international trade, (3) to promote exchange stability and to avoid competitive exchange depreciation, (4) to help re-establish a multilateral system of payments, (5) to provide means for the orderly correction of balance-of-payments maladjustments, and (6) to provide measures which lessen the severity of balance-of-payments disequilibria.

A member country experiencing a short-term balance-of-payments deficit may purchase needed foreign currencies from the Fund, which maintains a pool of currencies for this purpose. Such assistance is intended to help the member over *temporary* difficulties without its having to rely upon exchange control or exchange depreciation, and without its having to undergo unnecessary domestic deflation. A member experiencing a long-term balance-of-payments deficit (i.e., a *fundamental disequilibrium*), on the other hand, may depreciate its exchange rate, but only with the Fund's permission (if in excess of 10 per cent). The supervision over depreciation is intended to prevent a depreciation from becoming widespread.

The major shortcoming of the Fund has been its failure to promote the removal of exchange restrictions during the postwar years. The nature and scope of the Fund, so it is frequently alleged, did not allow it to cope adequately with the unique circumstances of this period.

SELECTED REFERENCES

Balogh, T., *The Dollar Crisis: Causes and Cure*. Oxford: Basil Blackwell & Mott, Ltd., 1949.

°Halm, G. N., *International Monetary Cooperation*. Chapel Hill: University of North Carolina Press, 1945, Chaps. VI-XII.

°Harris, S. E. (ed.), *Foreign Economic Policy for the United States*. Cambridge: Harvard University Press, 1948, Part V.

°International Monetary Fund, *Annual Report, 1954*, Washington, 1954. (See other annual issues also.)

°———, *Fifth Annual Report on Exchange Restrictions*, Washington, 1954. (See other annual issues also.)

Mikesell, R. F., "The International Monetary Fund," *Journal of Political Economy*, October, 1949.

Nurkse, R., "Domestic and International Equilibrium," in S. E. Harris (ed.), *The New Economics*. New York: Alfred A. Knopf, Inc., 1947.

°Williams, J. H., *Postwar Monetary Plans and Other Essays*. New York: Alfred A. Knopf, Inc., 1947, Part I.

21

European Recovery: I

ONE OF THE MAJOR world problems since the end of World War II has been the economic plight of Western Europe. This chapter discusses the origin and nature of some of Western Europe's postwar economic difficulties, and the major attempts made to deal with them.

WESTERN EUROPE AT THE END OF WORLD WAR II

The magnitude of the impact of World War II upon Western Europe was enormous, and it left its imprint in no unmistakable fashion. As seen at the end of the war, three major (and interrelated) economic effects appeared to be of utmost significance.

First, Western Europe's productive capacity was impaired as a result of the war. Some countries had suffered enormous physical damage, and their populations had been seriously disrupted. In most countries, industrial and transportation facilities had deteriorated badly through lack of repair or replacement. The normal delay in converting industry from wartime to peacetime production was certain to prove costly in terms of current output. In agriculture, too, equipment had fallen into a generally bad state of disrepair, and livestock herds were depleted.

It was to be expected, therefore, that production during the early post-

war years would be at low levels. In 1946, for example, industrial production in Western Europe was but 72 per cent of its 1938 level,[1] and output per man in industry was but 77 per cent of its 1938 level.[2] In contrast, in the United States, according to the Federal Reserve index of industrial production, industrial production in 1946 was 70 per cent above the average for 1935-39. The significant fact is that the industrial output of Europe, which before the war was one-third larger than that of the United States, as late as 1948 was less than three-fourths that of the United States.[3] Similarly, reduced output also characterized European agriculture; e.g., production in the 1946-47 crop year was only 78 per cent of the 1934-38 level.[4] In short, at the end of World War II Europe was confronted with impaired productive capacity, reduced levels of production, and reduced capacity for either consumption or exportation.

Second, the international-payments position of Western Europe deteriorated in consequence of the war. On the one hand, Europe's potential demand for imports increased greatly in view of the needs imposed by reconstruction but, on the other hand, her capacity to pay for such imports was greatly reduced. The impairment of Europe's ability to "pay her way" internationally was not limited to the curtailment of exports which resulted from physical deterioration and damage at home. Rather, the impairment extended also to Europe's claim upon earnings from "invisible" trade, i.e., investment and service income from abroad. These earnings, which totaled \$1.8 billion (net) in 1938, an amount sufficiently great to pay for one-third of total current imports, showed a deficit of \$0.1 billion in 1947 (Table 28).

Investment income decreased because of the liquidation during the war years by Western European countries of a substantial portion of their foreign assets, both private and public, in order to help finance imports in excess of those otherwise possible under the then-reduced volume of exports. For example, Great Britain, whose prewar earnings from overseas investments averaged about £200 million annually, liquidated external capital assets during the war years worth well over £1,000 million. The liquidation by Britain of her overseas investments continued after the war, disinvestment totaling £380 million in 1946 and £675 million in 1947, amounts equal to 4 and 8 per cent, respectively, of current national income. Moreover, the investments retained by the countries frequently yielded reduced incomes. This was especially true of direct investments

[1] UN, *Economic Survey of Europe in 1948,* Geneva, 1949, Table 1, p. 4.
[2] *Ibid.,* Table 4, p. 7.
[3] *Ibid.,* p. 23.
[4] *Ibid.,* Table 14, p. 17.

Table 28

Europe's Balance of Payments, 1938 and 1947
(billions of dollars in current prices)

Item	1938			1947		
	United States	Other non-European countries	Total	United States	Other non-European countries	Total
Europes imports (f.o.b.)	1.3	4.2	5.5	6.1	7.8	13.9
Europe's exports (f.o.b.)	0.6	3.1	3.7	0.9	5.5	6.4
Balance on trade account	—0.7	—1.1	—1.8	—5.2	—2.3	—7.5
Income from investment (net)	+0.1	+1.1	+1.2	. . .	+0.6	+0.6
Transportation (net)	+0.2	+0.4	+0.6	—0.7	+0.3	—0.4
Other invisibles (net)				+0.2	—0.5	—0.3
Balance on invisibles account	+0.3	+1.5	+1.8	—0.5	+0.4	—0.1
Balance on goods and services	—0.4	+0.4	. . .	—5.7	—1.9	—7.6

Source: UN, *Economic Survey of Europe in 1948*, Geneva, 1949, Table 71, p. 112.

which, in some instances, had suffered from neglect or damage while in enemy hands. Examples included British-owned plantations in Malaya and Dutch-owned plantations in the Dutch East Indies.

The decrease in service income was attributable largely to wartime shipping losses. Europe's loss of merchant shipping totaled 24 million gross registered tons out of a fleet of 44 million tons (1939). Even if adjustment is made for the 7 million tons of new construction and the 2 million tons lent by the United States during the war, Europe's total tonnage at the end of the war was but two-thirds that of prewar.[5] As for individual countries, the British merchant fleet, totaling 17 million tons in 1939, was smaller by one-fourth at the end of the war despite new construction and purchases, and the country's international earnings from shipping fell from a prewar level of about £100 million annually to about £60 million in the years immediately after the war. Similarly, Italy's postwar merchant fleet was only 16 per cent its prewar tonnage, France's 24 per cent, Denmark's 37 per cent, the Netherlands' 55 per cent, and Norway's 56 per cent.[6]

[5] UN, *Economic Survey of Europe Since the War*, Geneva, 1953, p. 5.

[6] UN, *Economic Report: Salient Features of the World Economic Situation, 1945-47*, Lake Success, 1948, Table 58, p. 130.

The loss of investment and service income held important long-run implications. Once the assets which give rise to such income are gone, it becomes very difficult for a country to create them anew. This is especially true if accompanying economic difficulties are so grave that capital is not readily available to move into foreign investment or into the service industries, e.g., shipping, which give rise to foreign income. In this sense, the loss of investment and service income is far more disastrous than is a lowered level of domestic production. The latter may prove only temporary, whereas the loss of investment and service income may for the greater part prove long-run, if not indeed permanent.

Third, in addition to lowered production and reduced foreign earnings, Western Europe was confronted with an environment in which serious distortions wrought by the war were certain to handicap the speedy resumption of foreign trade, essential to recovery. One serious impediment existed in the inflation which was current. While inflation was general throughout Europe during and after the war, domestic price levels varied widely, a natural development in view of the varying degrees of impact of the war and in view of the prolonged absence of "normal" or free-market trading relationships among countries. Thus, wholesale prices in Great Britain rose to 155 in 1945 and 202 in 1948 (1937=100), while the respective price indices for 1945 and 1948 in terms of 1937 were 422 and 1,924 in France, and 2,203 and 5,824 in Italy, and, among nonbelligerents, 265 and 400 in Spain, and 170 and 188 in Sweden; the respective indices on the same base were 123 and 191 in the United States.[7] The magnitude and prevalence of the price distortions posed an environment in which free, multilateral trade was not likely to thrive.

Another serious impediment existed in the schism which arose in Europe, between East and West, shortly after the war. Poland, the Baltic States, East Germany, Czechoslovakia, Hungary, Yugoslavia, Rumania, and Bulgaria, all of which were trading partners of the Western European countries before World War II, began to orient themselves economically toward the U.S.S.R. In prewar days these countries were important markets for the industrial output of Western Europe, as well as important suppliers of raw materials and foodstuffs. The virtual cessation of trade with these countries was certain to complicate further an already serious production and trade problem in Western Europe.

Western Europe's Balance of Payments

The impact of World War II upon the international economic position of Western Europe may be observed through a comparison of the balance-

[7] UN, *Statistical Yearbook, 1948*, New York, 1948, pp. 349-369.

of-payments situation before and after the war (Table 28). In 1938, Western Europe's deficit in merchandise trade amounted to $1.8 billion, but in 1947 the deficit was $7.5 billion, four times its prewar level. In 1938, net earnings of $1.8 billion from invisible-trade items balanced an equivalent deficit in merchandise trade, but in 1947 invisible-trade items showed a net deficit of $0.1 billion (net investment income had been cut in half and net shipping income had become minus). In 1947, therefore, a balance-of-payments deficit of $7.6 billion remained to be settled by other means (i.e., through the use of reserves or through borrowing).

Because of the improbability of materially increasing earnings from invisible-trade items, efforts at wiping out the balance-of-payments deficit of necessity (in the absence of use of reserves or resort to borrowing) had to be in the direction of an increase in exports, or a decrease in imports, or both. In order to maintain imports at the 1938 ratio, exports would have had to increase by 56 per cent. Or, in the absence of an increase in exports above the prewar level, a balancing of accounts would have required a reduction of 36 per cent in imports.[8] The actual situation in 1947, however, was that merchandise imports from non-European countries were 114 per cent of their 1938 volume, while exports to non-European countries were only 81 per cent of their 1938 volume.[9]

The deterioration in Western Europe's capacity to pay for imports constituted a serious problem because of the heavy dependence of most countries upon continued high levels of importation. While United States imports as a percentage of national income averaged about 4 per cent immediately prior to the war, the comparative figures for the countries of Western Europe ranged from about 10 to over 30 per cent. Under the circumstances, a long-run reduction in the volume of importation held important implications. First, a reduction in importation was likely to entail a reduction in exportation. This was to be expected since the exports of a number of European countries typically consist of manufactures which arise in large part through the processing of raw-material imports. Because of the relatively close interrelationship between imports and exports, a reduction of importation offered no real solution to Europe's payments deficits.

Second, a reduction in importation was likely to reduce the average standard of living. As matters stood, there was abundant evidence that real per-capita income in Europe in 1947 was substantially lower than prewar. According to the Economic Commission for Europe, per-capita

[8] UN, *A Survey of the Economic Situation and Prospect of Europe*, Geneva, 1948, p. 66.

[9] UN, *Economic Survey of Europe in 1948*, Geneva, 1949, Table 41, p. 57.

income in Europe (exclusive of the U.S.S.R.) had fallen from \$207 in 1938 to \$162 in 1947 (in terms of 1938 dollars), while comparable statistics indicated an increase in the United States from \$521 to \$665. In five countries (Denmark, Ireland, Norway, Sweden, and the United Kingdom) the decrease in per-capita income was from \$362 to \$352; in five other countries (Belgium, Luxembourg, France, the Netherlands, and Switzerland) the decrease was from \$262 to \$233; in Italy the decrease was from \$127 to \$100; in Greece and other countries of south and southeast Europe the decrease in income left the per-capita level well under \$100 in 1947.[10] The generally low standard of living which had come to prevail was no small factor in the rising discontent which, in a number of countries, was sufficiently widespread and intense to jeopardize the continued authority of the existing regimes. Under the circumstances, there was a distinct disinclination on the part of the governments concerned to pursue any policy likely to entail a further reduction in the standard of living. Hence, the emphasis was upon how a greater volume of vital imports might be procured and financed.

The Dollar Crisis

Some 70 per cent — \$5.7 billion — of Western Europe's balance-of-payments deficit in 1947 represented a deficit of dollars. It is this dollar deficit which constituted the so-called *dollar shortage.*

In general terms, a dollar shortage is said to exist whenever, under prevailing production and income patterns and under existing exchange rates, the demand within a particular country or area for dollar exchange to meet dollar payments exceeds the supply of dollars becoming available to that country or area. In a *statistical* sense, the magnitude of the dollar shortage is measured by the amount of dollars which the balance-of-payments indicates the country or area to be actually short of, considering the transactions which have occurred. The dollar deficit of \$5.7 billion experienced by Western Europe in 1947 was thus a statistical dollar shortage. Actually, Western Europe's potential dollar shortage (under the existing exchange rates) was somewhat larger but was prevented from arising in a statistical sense by means of measures (e.g., exchange controls) instituted to curb the demand for dollars. In this sense, Western Europe suffered from a *suppressed* dollar shortage of unknown amount in excess of the known statistical dollar shortage. In a free market, of course, there would have been no continuing dollar shortage, since changes in exchange rates would have served to eliminate the excessive demands for foreign exchange (although

[10] *Ibid.,* Table E, p. 235.

perhaps, or quite probably, at the same time producing severe consequences in other connections).

The dollar crisis which confronted postwar Europe was not entirely new. During the Great Depression, for example, when the volume of United States importation declined drastically, a dollar shortage (in the statistical sense) was experienced in Europe. While a dollar shortage was thus by no means an unknown factor in Europe prior to the end of World War II, the crisis which occurred during the early postwar period differed in that it assumed proportions theretofore unknown, and it occurred at a time when Europe was in a relatively poor position to do anything about it.

The postwar dollar crisis was attributable in the main to the opposite pull of two major forces, both of which had been intensified in consequence of the war and its lingering repercussions. On the one hand, Europe's capacity to produce and to export was drastically curtailed, while her need for imports was greatly increased. On the other hand, the productive capacity of the United States had risen pronouncedly, making this country the logical source from which Europe should attempt to obtain many of her needed imports. It was not unexpected, therefore, to find Europe heavily dependent upon the American economy during the early postwar years.

These and other shifts in trade which had occurred, postwar as compared to prewar, and which were an integral part of the circumstances eventuating in the dollar shortage are summarized in Table 29. While total *national* imports in 1947 (measured in terms of 1938 prices) were only 81 per cent of the 1938 level, total *national* exports were but 64 per cent as great as in 1938. On a regional basis, the imports of European countries from the United States and Canada almost doubled, 1947 as compared to 1938, but imports from other European countries (i.e., intra-European trade) were almost cut in half and "other overseas countries" supplied less than four-fifths as much as in prewar days. Significantly, however, the increased dependence of European countries upon imports from the United States and Canada was not matched by an increase in Europe's exports to the dollar area, nor was it offset through markedly increased exports to "other overseas countries" or through increased intra-European trade.

In prewar days, European countries were able to earn surpluses with "third" countries which could then be used to offset deficits with the dollar area. Following the war, in contrast, European countries came to be even more dependent upon the dollar area, but they failed either to achieve a bilateral balancing of accounts with the dollar area or to earn

Table 29

European Trade, 1947 compared with 1938
(indices of value in 1938 prices — 1938 = 100)

	Sources of European Imports	Destination of European Exports
European countries	55	55
United States and Canada	192	70
Other overseas countries	78	84
Total	81	64

Source: UN, *Economic Survey of Europe in 1948*, Geneva, 1949, Table 46, pp. 66-67.

surpluses with third countries sufficiently large to allow the deficits with the dollar area to be offset.

In short, Europe at the end of the war was confronted with an overall balance-of-payments deficit, and with a particular deficit vis-à-vis the dollar area. The pertinent question confronting Europe (and no less the United States) was *what* to do about the dollar deficit. While the immediate answer appeared to rest upon the receipt of outside assistance, the long-run answer appeared of necessity to depend upon other measures.

ASSISTANCE TO EUROPE

The effect of World War II thus was to create enormous economic problems for Europe. The problems of Europe, however, held implications also for countries outside Europe, especially for the United States. Because of the nature of the problems, and because of their impact upon the world economy, the United States decided that it could ill afford to stand aloof. Accordingly, this country undertook to extend special assistance to the countries of Europe.

Assistance given Europe by the United States during the postwar years reached its peak in the Marshall Plan (1948-51). Prior to the initiation of the Marshall Plan, however, the United States extended assistance under a number of other programs, a few of the more important of which bear mention here. During the war itself, large-scale assistance was given Europe by the United States through (1) the lend-lease program. During and after the war, important assistance was also rendered through (2) UNRRA (the United Nations Relief and Rehabilitation Administration). Following the termination of hostilities, assistance rendered included

that occurring through (3) GARIOA (Government and Relief in Occupied Areas), (4) the Anglo-American Financial Agreement, (5) the programs arising from the Truman Doctrine, and (6) the Interim-Aid program. (In addition, assistance was rendered through the IMF, the IBRD, and the Export-Import Bank, all of which institutions have previously been discussed.)

1. **Lend-Lease Aid.** The Lend-Lease Act, approved in March, 1941, was initiated by the United States as a means to assist countries fighting the Axis powers. The Act authorized the President "to sell, transfer, exchange, lease, lend, or otherwise dispose of" any defense article to any country whose defense the President deemed vital to the interests of the United States. During the period up to October 1, 1945, the United States granted lend-lease aid in excess of \$47 billion, 69 per cent of the total going to Great Britain and 25 per cent to the U.S.S.R.[11] Settlement was to be postponed until after the termination of hostilities, and was to be handled in a manner which would not impair the international-payments structure.

Final settlement included an offset of over \$8 billion for "reverse lend-lease" received by the United States. That portion of the British obligation not accounted for through reverse lend-lease was settled for through payment of \$650 million from the proceeds of a new loan of \$4.4 billion granted Great Britain in 1946 by the United States Government. Efforts to effect a final settlement with the U.S.S.R. proved less amicable. The United States, which had initially set her claims at \$1.3 billion (for a stock of lend-lease goods having an estimated value of \$2.6 billion when placed in postwar civilian use), offered during official talks in 1951 to scale down her demands to \$800 million. Russia offered to pay \$300 million, but the United States held this amount to be unsatisfactory. In addition, Russia failed to return the great bulk of the naval and merchant ships and boats loaned her under the lend-lease program. During 1952, the United States Government stated its intent to submit its claims against Russia to the International Court of Justice for final adjudication.

2. **UNRRA.** The United Nations Relief and Rehabilitation Administration, sponsored by forty-four anti-Axis powers, was begun during World War II in order to provide for the relief and rehabilitation of the peoples of those countries which were war-ravaged in the course of their

[11] A relatively small amount of lend-lease aid was granted between the end of the war and the close of fiscal year 1950. Total lend-lease aid, wartime and postwar, amounted to \$49.1 billion. See U. S. Department of Commerce, *Foreign Aid by the United States Government, 1940-1951,* Washington, 1952, for a résumé of wartime and early postwar foreign aid.

resistance of the Axis powers. Some \$3.7 billion in assistance was provided during the period November, 1943, through June, 1947. The organization was financed through contributions from those participants which had not been invaded, some 73 per cent of the total cost being borne by the United States. Expenditures were heavily concentrated on food and medical supplies.

In May, 1947, the United States took it upon itself to introduce a Post-UNRRA Aid Program, authorizing additional assistance of \$350 million for Austria, Greece, Italy, Trieste, and China.

3. **GARIOA.** The armed forces of the United States, acting through GARIOA (Government and Relief in Occupied Areas), also supplied foreign assistance. From mid-1945 to the end of 1948, \$3.2 billion was spent for relief, \$1.9 billion in Europe and the remainder in Asia. During 1948 the conclusion was reached that dependence upon grants would be indefinitely prolonged unless economic recovery was stimulated in the occupied areas. In consequence, the program was altered from one of relief to one of relief and recovery. The budget for fiscal year 1949, for example, was split into two sections, \$1.2 billion for GARIOA and 150 million for a supplemental program, ERIOA (Economic Rehabilitation in Occupied Areas). During 1950 most of the "assistance" aspects of these programs, as they applied to Europe, were shifted to other programs or agencies. In Asia, GARIOA and ERIOA continued in operation, but budgets were of declining magnitude.

4. **The Anglo-American Financial Agreement.** The balance-of-payments deficits of Great Britain, particularly as reflected in the magnitude of her dollar shortage, proved particularly acute following the war. The loss of earnings from invisible-trade items had been especially great in her case, and her dependence upon imports was among the highest. As her international reserves, especially dollar reserves, declined to a precariously low level, devaluation became a distinct possibility. Since there appeared to be compelling reasons at the time why such should not be permitted, alternate means were sought to relieve pressure.

In an attempt to bolster the country's balance-of-payments position, a loan agreement, the Anglo-American Financial Agreement, was concluded by United States and British Treasury officials, and ratified by Congress in July, 1946. Terms of the loan agreement were as follows: (1) the United States agreed to advance \$3,750 million to Great Britain over a four-year period. (2) Britain's obligation for lend-lease aid received was set at \$650 million. (3) Britain agreed to repay the \$4,400 million over

a fifty-year period, beginning in 1952, interest being set at 2 per cent. (4) Britain agreed to initiate steps intended to culminate in full convertibility on or before July 15, 1947.

The elimination of price control in the United States, followed by rising prices, served to increase the cost of British purchases in the American market. This fact, along with heavy withdrawals by countries having a surplus in their British accounts, caused the loan proceeds to be drawn upon at a pace much faster than initially anticipated. In any event, a new, and greater, dollar crisis arose in 1947, which precluded all possibility of a movement to full convertibility at that time.

5. The Truman Doctrine. As Great Britain's economic difficulties mounted, she concluded that she could no longer shoulder the financial burden of maintaining the status quo in the eastern Mediterranean. For many years Great Britain maintained military and naval forces in this part of the world and, in addition, undertook to underwrite the military establishments of Greece and Turkey (presumably in order to create a bulwark against possible encroachment by the Soviet Union). The expenditures in Greece and Turkey proved costly to Great Britain in terms of foreign exchange. This was especially true following World War II since Greece was in the throes of civil war and Turkey required outside assistance in her efforts at remilitarization. In consequence, Great Britain, heavily laden with other commitments and lacking adequate means, felt compelled to retrench from her long-established position in the area.

In order to prevent any "power vacuum" from developing which might threaten the status quo, the United States set forth the so-called Truman Doctrine, a policy of "containment" aimed at the Soviet Union. As a starting measure, Congress passed the Greek-Turkish Aid Act in May, 1947, under which the United States extended $300 million in military and economic aid to Greece and $100 million in military aid to Turkey. In reality, as applied to these countries, the United States had served notice by word and action that she would assume some of the commitments formerly shouldered by Great Britain.

6. Interim Aid. Widespread acceptance during 1947 of the view that "free" Europe was threatened by political and economic breakdown unless further assistance in substantial amount was forthcoming in rapid fashion led the United States to consider additional measures. Pending the formulation of an integrated program of assistance, Congress approved aid on a stopgap basis. Approval in December, 1947, of the so-called Interim-Aid program made available $597 million for use in Austria, France, and Italy.

THE ORIGIN OF THE MARSHALL PLAN

Gross foreign aid rendered by the United States between the end of World War II and early 1948 totaled \$16.8 billion, \$8.1 billion in grants and \$8.7 billion in loans.[12] Despite foreign aid of this amount, the economic outlook in Western Europe at the outset of 1948 appeared far from promising. The economic situation, which had appeared to improve immediately after the war, had taken a turn for the worse during 1947, especially during the latter half of that year. New factors which served to bring on the "crisis of 1947" included the following: (1) The severe winter of 1946-47, which crippled transportation and hampered production, was followed by widespread drought and crop failures in the summer of 1947. (2) Industrial production was hampered by raw-material and fuel shortages. (3) Intra-European trade neared a complete breakdown as payments difficulties were compounded. (4) Rising prices in the United States, which followed decontrol, greatly reduced the purchasing power of Europe's gold and dollar reserves, and served to bring on a dollar crisis of unprecedented severity in 1947.

All considered, the economic plight of Western Europe was of sufficient gravity to threaten political stability, especially since communism was already a close neighbor. Surveying this situation in a commencement address delivered at Harvard University in 1947, Secretary of State Marshall expressed the opinion that the United States was willing to help Europe tackle its problems on a unified and coordinated basis. In part, he stated as follows:

> It is logical that the United States should do whatever it is able to do to assist in the return of normal economic health in the world, without which there can be no political stability and no assured peace. . . . Such assistance, I am convinced, must not be on a piecemeal basis as various crises develop. Any assistance that this Government may render in the future should provide a cure rather than a mere palliative . . . [To] start the European world on its way to recovery, there must be some agreement among the countries of Europe as to the requirements of the situation and the part those countries themselves will take in order to give proper effect to whatever action might be undertaken by this Government.[13]

[12] Data cover the period from July 1, 1945, to the beginning of the European Recovery Program. The total of \$16.8 billion is exclusive of "offsets" to grants. Data from U. S. Department of Commerce, *Survey of Current Business,* Washington, May, 1952, Table 1, p. 15.

[13] *Department of State Bulletin,* June 15, 1947, p. 1159.

Two points appeared particularly significant: (1) Assistance to Europe should not be "on a piecemeal basis as various crises develop." Assistance "should provide a cure rather than a mere palliative." (2) Europe's problems should be dealt with as a whole, and "there must be some agreement among the countries of Europe as to the requirements of the situation and the part those countries themselves will take" in making United States aid effective.

The ideas put forth by Secretary Marshall were rapidly translated into action. The United States undertook to survey Europe's problems and needs, as well as this country's capacity to give assistance, and a comprehensive program was formulated. The so-called Harriman Committee, one of three committees established in the United States to survey particular aspects of the proposed aid program, estimated the cost to this country of a four-year European Recovery Program (ERP) at between \$12 and \$17 billion. Legislation in the form of the Economic Cooperation Act was approved by Congress in April, 1948. This Act established the Economic Cooperation Administration (ECA), and made available \$5 billion for the first twelve-month period of operation.

Meanwhile, in Europe, sixteen countries[14] (Austria, Belgium, Denmark, France, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Sweden, Switzerland, Turkey, and the United Kingdom; the U.S.S.R., although invited, did not participate) had joined in the Committee of European Economic Cooperation (CEEC) in order to survey Europe's problems and needs, and to propose specific action, both within individual countries and on an overall basis, which might promote recovery. CEEC estimated Europe's need for external assistance at \$19.6 billion for the ensuing four-year period. As soon as action on ERP had crystallized in the United States, the European countries replaced CEEC with the Organization for European Economic Cooperation (OEEC). The latter was intended to serve as the European counterpart of ECA, and was to have as its primary function the integration of the plans of individual countries within a mutually compatible framework.

For the full period of the program — April 3, 1948, to December 31, 1951 — aid furnished by the United States totaled \$11.4 billion.

THE OBJECTIVES OF ERP

From the standpoint of the United States, the inauguration of ERP was motivated by both political and economic factors. Politically, it was

[14] Western Germany was included in proposals, although at the time it continued to be under Allied military control.

widely feared that the inroads of communism in Europe might be extended unless concerted action occurred to assure speedy economic recovery. Economically, there appeared to be growing distaste for repeated doses of foreign aid which, though helpful, never quite sufficed to restore the economic health of Europe. Accordingly, ERP was devised as a program of large-scale assistance by the United States to the cooperating countries of Europe, the overall objectives of which were, first, to forestall the spread of communism and, second, to make the cooperating countries, barring unforeseen developments, independent once and for all of extraordinary outside assistance by 1952 (i.e., a program of "*aid to end aid*").

The objective of freeing Europe of the need for extraordinary outside assistance by 1952 was to be achieved, according to the plans of ERP, through efforts directed toward two major goals: (1) an increase in the domestic *production* of the cooperating countries, and (2) a solution of their *external-payments* problems. To a large extent, attainment of the two goals called for similar (or overlapping) action; the achievement of the one tended in turn to facilitate achievement of the other. In so far as the two may be segregated, it was hoped to increase domestic production, in the main, through (*a*) support of needed imports of equipment and supplies, (*b*) support of internal measures designed to promote financial stability, and (*c*) encouragement of closer economic cooperation among the participating countries of Europe. Similarly, it was hoped to alleviate the external-payments problem, especially as it related to the dollar shortage, through (*a*) greater domestic production, which would increase the capacity of the countries to export, and (*b*) greater emphasis upon intra-European trade, the effect of which would be to reduce the dependence of individual countries upon imports from non-European countries (e.g., from the United States, with which a particularly serious payments problem prevailed).

ERP IN OPERATION

Before turning to an examination of the effect of ERP upon European production and payments, we may examine the manner in which ECA aid was made available.

1. **Program Integration.** Each cooperating country was made responsible for the formulation of an individual recovery plan for the four-year period, 1948-51. Such national plans were to propose specific measures designed to increase production and reduce balance-of-payments deficits. Individual national plans were subject to review by OEEC in order to assure an integrated and unified approach toward recovery problems.

2. **Screening by ECA.** National plans approved by OEEC were, in turn, subject to review by ECA. This screening by the United States had a two-fold purpose. First, the procedure was designed to allow assistance only in so far as the resources of individual countries were inadequate to support the recovery measures agreed upon. In short, the United States was to provide "marginal" assistance, and was not to foot the entire bill. Second, the review by ECA gave the United States a measure of control over the policies of the cooperating countries. As a condition of assistance, ECA could insist upon domestic and foreign economic policies on the part of cooperating countries which would facilitate correction of basic maladjustments. For example, ECA could deny aid to a country experiencing a balance-of-payments deficit if that country persisted in pursuing highly inflationary domestic policies (e.g., heavy domestic investments or costly social and economic reforms) which tended to aggravate its difficulties. In a sense, therefore, matters theretofore regarded as fundamental to sovereignty became subject to a degree of international control.

3. **Form of Assistance.** ECA extended aid on three bases: direct grants, loans, and "conditional grants." Conditional grants referred to aid extended to a country on condition that it in turn grant specific forms of assistance to other participating countries. Almost 90 per cent of all assistance was treated as an outright grant.

4. **Transmission of Assistance.** While assistance was transmitted from the United States to the participating countries in any one of several ways, the following "purchase procedure" was not unrepresentative and, in any event, serves to illustrate the essential mechanics involved in the transfer process: (1) Congress appropriated funds for use by ECA. (2) These funds were apportioned among the cooperating countries by OEEC, subject to approval by ECA. (3) The cooperating governments, or private domestic enterprises authorized by them, contracted for goods from the United States. (4) American suppliers received "claims" payable in dollars in the United States. (5) The importing country set aside an equivalent value in domestic currency for goods so received. Such "payment," deposited within the cooperating country, constituted a so-called "*counterpart fund.*" (6) The United States assumed full control of 5 per cent of this amount, employing it primarily to defray expenses incurred by this country in administering ERP within the cooperating country. (7) The remaining 95 per cent was made available to the cooperating government for use in some manner designed to raise domestic production and to reduce international-payments deficits. The manner of use was a matter of joint determination between the cooperating government and the

United States; in addition, the United States (through ECA) retained veto power. In practice, about one-third of counterpart funds was used to retire government debt (thereby striking at the inflation problem, at least in so far as the country did not initiate an offsetting increase in debt), and about two-thirds was used to promote domestic investment designed to increase export capacity or to reduce import requirements.

5. **ECA-financed Shipments.** Of the $11.4 billion spent, almost 10 per cent was required to cover ocean freights on goods transmitted. The remainder (exclusive of amounts used for the European Payments Union — discussed at a later point) was used to finance exports of goods: 36 per cent for food, feed, and fertilizer; 15 per cent for fuel; 33 per cent for raw materials and semi-manufactured goods; 14 per cent for machinery and vehicles; and the remainder for miscellaneous exports. Major recipient countries included the United Kingdom (24 per cent), France (20 per cent), Germany, Fed. Rep. (11 per cent), and Italy (10 per cent).

THE RECORD OF ERP

Did ERP achieve its objectives? We may briefly examine its record as to its success in promoting (*a*) political stability, (*b*) increased production, and (*c*) balance-of-payments equilibrium.

Political Stability

One of the objectives of ERP was to offer economic aid which might allow domestic economic improvements to occur in rapid fashion and thereby preclude the possibility of the countries concerned falling prey to communism. At the time ERP was inaugurated, the future political status of several European countries was definitely in question (e.g., France, Greece, and Italy). It is, of course, difficult to determine in precise fashion the amount of credit due ERP in halting the westward movement of communism in Europe. Of perhaps greater significance in this connection was the inception of NATO (the North Atlantic Treaty Organization) in 1949.[15] It appears significant, however, that not one additional European country moved behind the "iron curtain" after 1948.

Production

One of the objectives of ERP was to assist Western Europe to achieve a higher level of production. While there is again no precise way of

[15] The North Atlantic Treaty is a twenty-year collective alliance between the United States, Canada, and ten countries of Western Europe. Each member committed itself to come to the defense of any member subjected to an armed attack.

measuring the direct effects of ECA assistance, the record shows that the index of industrial production, 1951 as compared to 1947, increased from 89 to 120 (1938=100) in Great Britain and the increase in the other participating countries (average) was from 84 to 145.[16] In 1951, industrial production in Western Europe was approximately 40 per cent greater than prewar (1938), and agricultural production was about 10 per cent above prewar.[17]

Taking into account population increases, changes in the terms of trade, and losses in earnings from invisible-trade items, real national income per population in 1951 exceeded prewar levels by 10 per cent in the Netherlands, 10 to 15 per cent in the United Kingdom, France, and Denmark, 20 per cent in Switzerland, 25 per cent in Belgium, and over 30 per cent in Sweden. In Italy the level only equaled that of prewar, and in western Germany, where recovery was begun relatively late, the level still remained below that of prewar.[18]

It appeared, therefore, that production in Western Europe as a whole and per-capita income in most countries rose during the period of the Marshall Plan. Did the increase in production, however, occur along the lines of comparative advantage? That is, did the new productive capacity which was built up give rise to output in which the countries concerned held a comparative advantage? Unless the answer is affirmative, grave doubt is cast upon the long-run value of the productive capacity for the countries concerned. Even a cursory examination of the direction taken by production gives one reason to doubt that all increases in production occurred in lines in which a comparative advantage existed. The actual picture is mixed. It must be remembered, however, that the Marshall Plan sought to assist "recovery" in Europe; it did not set out to "remake" Europe. For the greater part, therefore, the prewar types of industries, whether or not well-situated from an economic standpoint, were continued; the addition of entirely new industries, or the shift of effort between industries or countries, though to some extent a product of the Marshall Plan, was largely secondary.

Balance-of-Payments Equilibrium

It was generally recognized during the early postwar period that Western Europe would require an increased volume of imports in order to meet its reconstruction needs. It was further recognized that payments for such increased imports would prove difficult, particularly since earn-

[16] UN, *Economic Survey of Europe Since the War*, Geneva, 1953, Table 1, p. 239.
[17] UN, *Economic Survey of Europe in 1951*, Geneva, 1952, p. 21.
[18] UN, *Economic Survey of Europe Since the War*, Geneva, 1953, p. 55.

ings from invisible-trade items were markedly below prewar and since productive capacity was impaired. The solution appeared to rest largely upon the raising of production to a level which would permit a greatly expanded volume of exportation. The idea behind the Marshall Plan, basically, was to assist the countries, through various means, to raise their levels of production, and in so doing to create a situation in which export volume could rise relative to import volume, thereby leading to the elimination of balance-of-payments deficits. In practice, however, it was soon realized that the increased exportation which followed from greater domestic output did not necessarily suffice to promote equilibrium in Western Europe's international accounts. Despite the aim of the Marshall Plan to make Western Europe independent of extraordinary outside assistance by the end of 1951, large-scale deficits (dollar deficits) requiring outside assistance continued beyond that date.

Gradually the realization was driven home that the continuation of Western Europe's balance-of-payments deficits rested, not only upon a marked imbalance between total imports and total exports, but more particularly upon *changed external circumstances* which governed and limited the possibilities of readjustments in exports and imports, and which resulted in a fluctuating, but persistent, dollar shortage. As previously indicated, Western Europe experienced dollar deficits prior to World War II, so that the postwar dollar problem as such was not entirely new. The postwar dollar shortage differed from the prewar shortages, however, both in size and in the mode of adjustment open to countries. Prior to the war, Western Europe was able to offset its deficit with the dollar area through the use of surpluses earned in trade with third countries. In consequence of the war, the regional distribution of Western Europe's imports and exports was so altered that the restoration of a multilateral-payments system proved extremely difficult.

An examination of the change in the pattern of trade indicates the nature of the problem which has confronted Western Europe. Reference to this change has already been made in Table 29, and Table 30 indicates the situation in greater detail (all dollar amounts in the latter are shown in terms of 1948 prices). It may be noted that Western Europe's exports rose far more rapidly between 1948 and 1951 than did its imports. In fact, postwar imports remained below the prewar level, while exports in 1951 were some 40 per cent over the 1938 level. These facts would indicate that an improvement had taken place in Western Europe's external-payments position. If an improvement, it nevertheless did not represent a solution, as may be shown through an area-by-area analysis of trade. As for the origin of imports, it may be noted that following the war Western

Table 30

Western Europe's Trade with Other Areas, Selected Years
(billions of dollars at 1948 prices)

	Imports [1]			Exports		
	1938	1948	1951	1938	1948	1951
Dollar area	5.2	6.2	6.7	2.0	1.7	3.3
Overseas sterling area	4.4	4.0	4.4	2.6	3.4	4.6
Dependent territories	2.2	2.0	2.2	1.0	1.3	2.3
Non-dollar Latin America	2.1	2.0	1.4	1.2	1.0	1.6
Other overseas countries	2.4	1.2	1.8	1.6	1.0	1.6
Eastern Europe	3.2	1.2	.8	1.6	.8	.7
Total [2]	19.4	16.6	17.4	10.0	9.1	14.2

[1] Value c.i.f.
[2] Sums of individual items do not necessarily add to totals because of rounding.

Source: UN, *Economic Survey of Europe Since the War*, Geneva, 1953, pp. 86, 100.

Europe imported less from Eastern Europe and from non-dollar and non-sterling areas outside Europe. Purchases from these regions, which in 1938 supplied Western Europe with some 40 per cent of its imports, were at approximately one-half the prewar level in 1948, and remained at this relatively low level through 1951. Moreover, imports from the overseas sterling area and dependent territories made up none of this deficiency. The result was that Western Europe continued to be extremely dependent upon the dollar area, importing some 30 per cent more (in terms of 1948 prices) from it in 1951 than in 1938. As for the destination of exports, Western Europe's sales to affiliated overseas countries in 1948 far exceeded the 1938 level, whereas exports to other non-dollar countries were somewhat below the prewar level. This situation continued substantially unchanged through 1951. While Western Europe's exports to the dollar area almost doubled between 1948 and 1951, this volume in 1951 was nevertheless still only about one-half that of imports from the dollar area.

The foregoing pattern of imports and exports could give rise to equilibrium in Western Europe's dollar accounts only if the affiliated overseas countries earned a substantial dollar surplus (which did not occur during this period), or if Western Europe could secure its required imports from the affiliated overseas countries or from other non-dollar countries (which, again, did not prove possible). As long as the prevailing volume and direction of trade continued substantially unchanged, concluded a United

Nations report, "there could be no resumption of a free flow of international trade and payments, and hence no question of restoring currency convertibility."[19]

POST-MARSHALL PLAN AID

The persistence of Western Europe's payments difficulties served to raise the question of the need for continued outside assistance following termination of ERP. The immediate rationale for further dollar aid stemmed from the extra burdens placed upon the economies of those foreign countries which had chosen to participate in a joint defense program with the United States following the outbreak of the Korean conflict in 1950. To the extent that the countries were obliged to channel resources into defense, their export potential was diminished and their import needs accelerated, thereby accentuating their balance-of-payments difficulties. The United States Congress, therefore, in 1951 approved the Mutual Security Act, which established the Mutual Security Agency (MSA) and authorized further dollar aid (either as "*military aid*" or as "*economic aid*") to the various participating countries, both in Western Europe and in the Far East.[20] MSA thus in a sense continued the work of ECA. In 1953, the work of MSA was, in turn, assumed by the Foreign Operations Administration (FOA).

The magnitude of United States foreign economic and military aid during the period 1946-53, roughly the other side of the picture of the world's postwar dollar deficits (largely centered in Europe), is indicated in Fig. 11. It may be noted that after 1949 economic aid decreased in amount, while military aid increased, but that the total of the two remained at relatively high levels.

A technique of considerable significance employed by the United States since 1952 is that of "*offshore procurement*." Under it, the United States purchases military-aid items in a foreign country and then gives these items to that or another foreign country. The practice of offshore procurement is intended to encourage friendly countries in their defense efforts; in addition, it serves to put dollars at the disposal of countries short of dollars. In essence, the United States "imports" goods (even though consumed abroad), whereas foreign countries register an increase in their "exports." The offshore-procurement program thus involves the granting of military aid, but it has the secondary effect of providing

[19] *Ibid.*, p. 19.

[20] Through June 30, 1953, less than 5 per cent of total MSA appropriations were for the Far East.

economic aid. Contracts placed under the offshore-procurement program amounted to approximately \$0.6, \$1.6, and \$1.0 billion during fiscal years 1952, 1953, and 1954, respectively.

THE "DOLLAR SHORTAGE": A RÉSUMÉ

The aggregate balance-of-payments deficit of the rest of the world with the United States during 1946-53 is shown in Fig. 12. This deficit is shown as the difference between "world dollar outlays" (United States

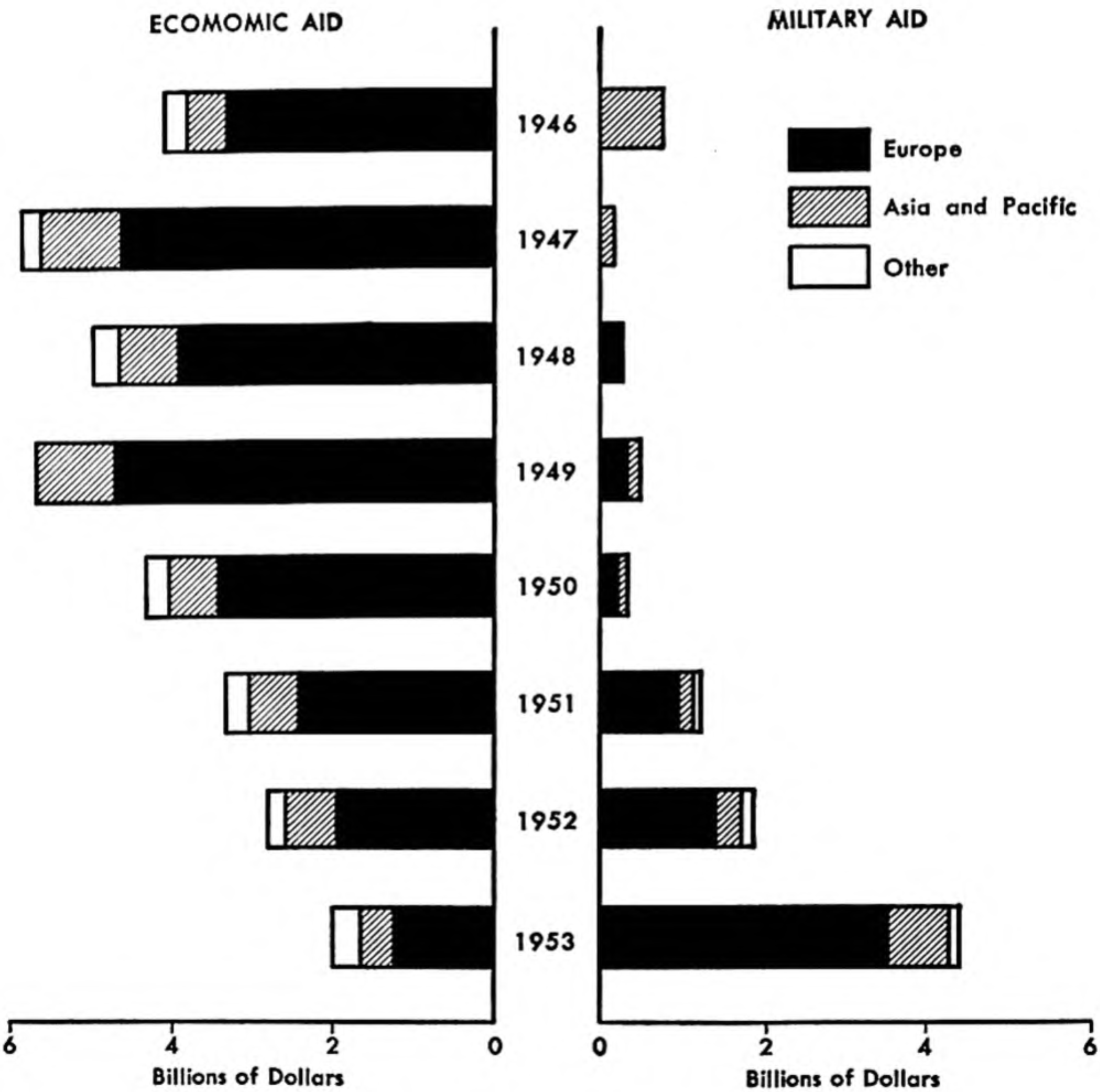


Figure 11

Net Foreign Aid Extended by the United States, Fiscal Years 1946-1953

Source: Based on *Staff Papers*, Commission on Foreign Economic Policy, Washington, February, 1954, Chart 1, p. 36.

exports of goods and services plus net United States imports of foreign long-term capital) and "world dollar earnings" (United States imports of goods and services plus net United States exports of private capital). The deficit, shown as the shaded portion of the graph, represents the statistical dollar shortage. It may be noted that the dollar shortage reached its peak during 1947, and remained large until after the currency devaluations of 1949 (mentioned in Chapter 20 and discussed further in Chapter 22). Since that time, the dollar shortage has varied considerably in magnitude. Following the outbreak of the Korean conflict, the dollar shortage increased somewhat, but during 1953 a slight dollar surplus was registered.

Fig. 13, in turn, indicates how the dollar shortage was financed. Two statistical series are shown. One series represents fluctuations in the dollar shortage (shown in Fig. 12 as the shaded area between the two series), and the other series shows changes in United States gold holdings and in net short-term liabilities to foreign governments and banks (i.e., foreign

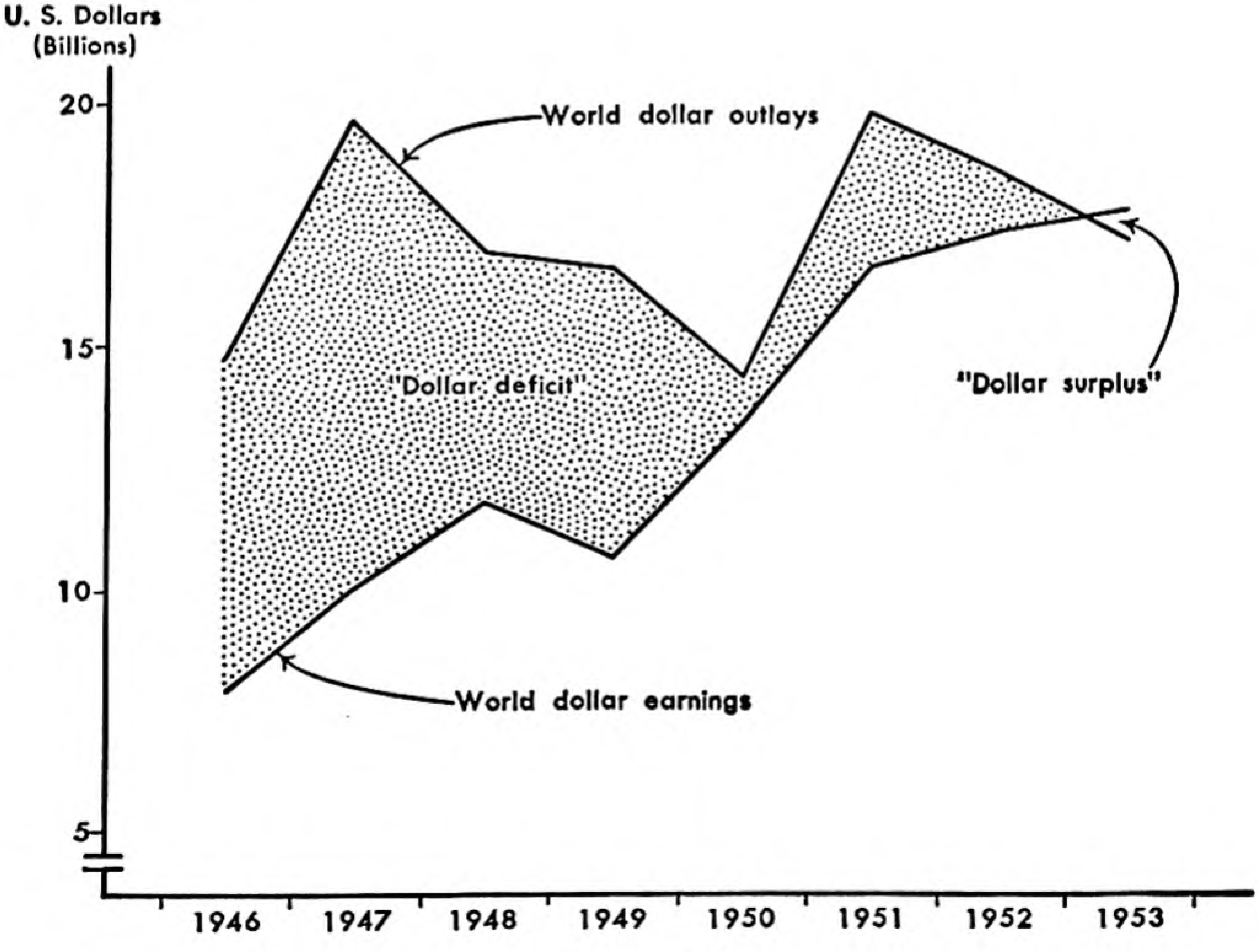


Figure 12

The Dollar Shortage, 1946-1953

Source: Based on data contained in Table 23, Chapter 14.

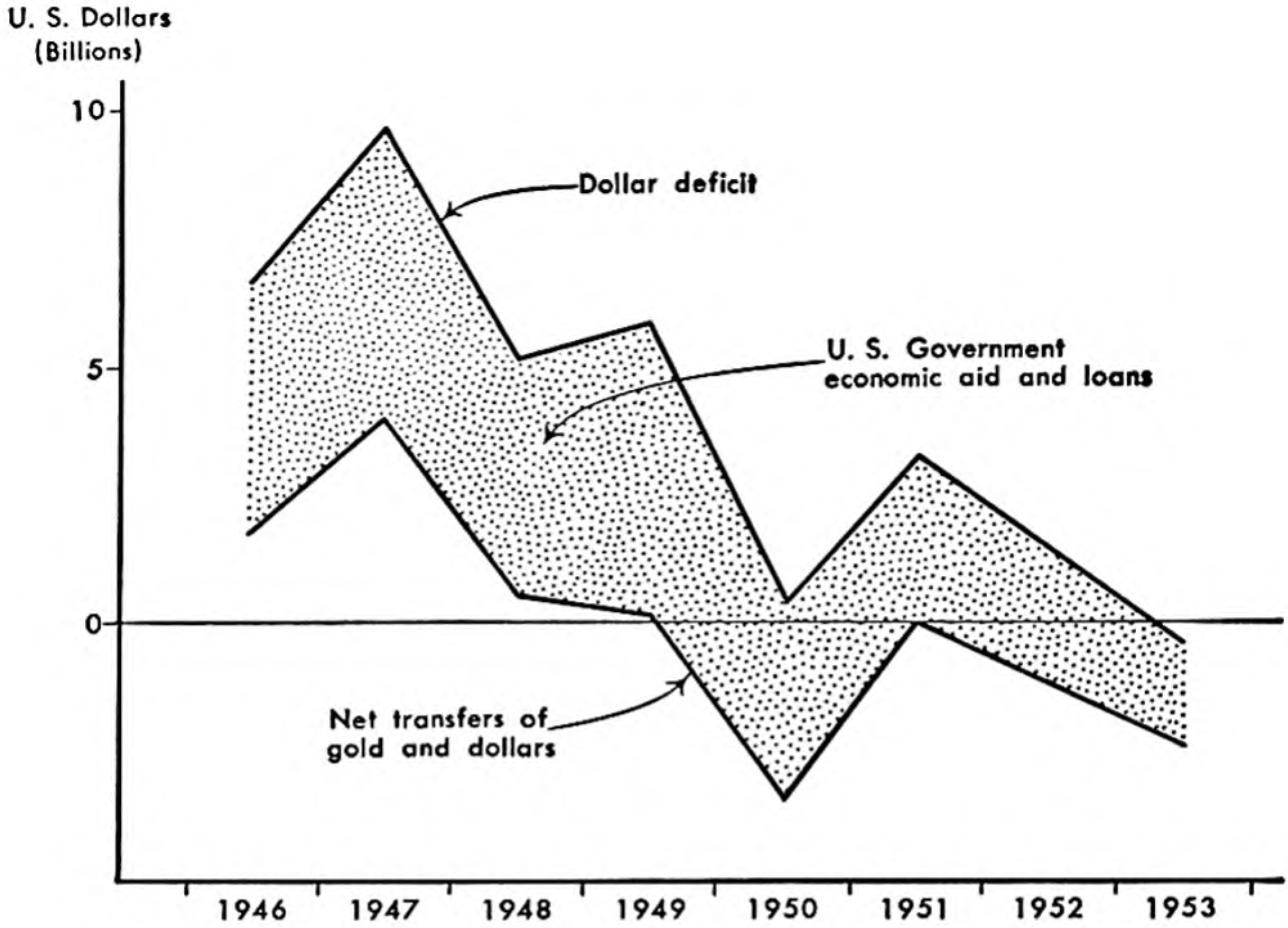


Figure 13

Financing the Dollar Shortage, 1946-1953

Source: Based on data contained in Table 23, Chapter 14.

official dollar reserves). Hence, the distance between the two series (shaded portion of the graph) indicates the additional financing, in the form of economic aid and loans, extended by the United States Government during the period in question.

SUMMARY

At the close of World War II, the countries of Western Europe were faced with the task of economic recovery. Basically, there were two aspects to the recovery problem: (1) production was at a relatively low level, and (2) large-scale balance-of-payments deficits prevailed, especially as reflected in a "dollar shortage."

The recovery efforts of individual countries during the early postwar years achieved only limited success, and in 1947 a major crisis arose which appeared to thwart further improvement. At this point the United States, which during and after the war had extended considerable aid to Europe

in various connections, proposed the Marshall Plan. Under the program put into effect, the United States offered large-scale economic assistance to the countries of Western Europe, the hope being that through an all-out effort their recovery might prove sufficiently rapid and great to enable them at the end of four years to proceed without further dependence upon extraordinary outside assistance (i.e., the United States offered "aid to end aid").

Substantial progress was made, particularly in promoting an expansion in production. International payments difficulties persisted, however, requiring foreign aid beyond the termination of the Marshall Plan. The dollar shortage, which had appeared to be well on its way to extinction by late 1949 and early 1950, again assumed larger proportions in 1951, following the outbreak of the Korean conflict.

SELECTED REFERENCES

See end of Chapter 22.

22

European Recovery: II

WESTERN EUROPE's persistent postwar economic problem has been the dollar shortage. The belief on the part of some persons that the dollar shortage would automatically disappear as production was increased proved to be in error. Even after aggregate production had equaled, and even exceeded, the prewar level, the dollar shortage continued in varying degrees of intensity. Many persons concluded quite early that special efforts would be required to eliminate the external-payments problem with which each of the countries of Western Europe was confronted, some to a greater extent than others. The specific courses of action proposed fell into three general categories: (1) economic integration, (2) monetary reform, and (3) structural readjustment (i.e., a realignment of trade).

This chapter describes the action taken along each of these lines, and discusses some of the problems related to this action.

ECONOMIC INTEGRATION

One approach to the solution of Western Europe's balance-of-payments problem is through *"economic integration."* Economic integration, as applied to Europe, implies the removal of all artificial barriers to intra-European trade and payments. In the event of "full" economic integration,

the countries concerned in reality constitute one large market, rather than a number of national markets, each set apart from the others by means of a maze of tariffs, quotas, exchange controls, and other national controls.[1]

Advocates of economic integration generally point to two possible ways in which it may help solve the common external-payments problem of a group of countries. First, through economic integration it is possible to promote greater productive efficiency (i.e., lower costs). For example, (*a*) more intensive competition between producers in the various countries tends to break down resistance to innovation, (*b*) an approach to a "single market" tends to promote the utilization of resources in a manner more nearly in harmony with the dictates of the law of comparative advantage, and (*c*) a pooling of resources and markets tends to bring with it the benefits of large-scale production. Applied to Western Europe, greater productive efficiency serves to strengthen the capacity of the countries concerned to sell in other parts of the world. Second, through economic integration it is possible to reduce the dependence of the countries in question upon sources of supply outside the area of integration. Applied to Western Europe, economic integration offers a way to replace imports from outside the integrated area (especially imports payable in dollars) with imports obtainable within the integrated area.

The Beginnings of Economic Integration

Despite frequent proposals and discussions aimed at a pooling of Europe's resources and markets, few achievements were recorded before World War II. It was not until after the war — actually not until 1948 or later — that any marked enthusiasm for economic integration was shown. During roughly the second half of the Marshall Plan period, a number of specific proposals were made. Partly in consequence of the urging and help of the United States, some of the proposals were adopted.

The accomplishments thus far have been modest, and it cannot seriously be maintained that inter-country barriers have been markedly reduced within Western Europe. No small amount of resistance arose to thwart some of the proposals and efforts. A recent United Nations report, in evaluating past progress and future prospects, summarized the situation as follows:

[1] As interpreted by Paul G. Hoffman, Administrator of ECA, economic integration is "the formation of a single large market within which quantitative restrictions on the movements of goods, monetary barriers to the flow of payments and, eventually, all tariffs are permanently swept away." See J. Viner, *The Customs Union Issue* (New York: Carnegie Endowment for International Peace, 1950), p. 132.

> The modest achievements in economic integration within western Europe give little reason for optimism about the future prospects, especially when it is remembered that, in the post-war period, conditions were in some ways favorable for bold steps towards international economic integration. In those years, at least one fundamental prerequisite was present: there was general economic expansion. When production is rising everywhere, . . . adaptation of production structures to the requirements of the international division of labor should be less costly and meet less resistance. . . . Without continued economic expansion, even the most modest steps towards international integration have little chance of success.[2]

Some of the attempts to promote economic integration — including successes, qualified successes, and failures — are summarized below.

International Movements of Labor and Capital

Little has been accomplished within Europe itself to facilitate the inter-country movement of labor or capital.

During the interwar years, widespread unemployment throughout Europe posed an insurmountable obstacle to the mass migration of labor. Following World War II, in contrast, unemployment was largely confined to southern Europe and western Germany, while the countries of northeastern Europe had full employment, sometimes accompanied by acute labor shortages in particular industries. From an economic standpoint, conditions appeared favorable for supporting labor shifts, at least to the extent that the surplus labor of some countries might be employed on a short-term basis to relieve labor shortages in other countries. Proposals that governments undertake to direct the movement of masses of workers from labor surplus countries to labor deficit countries proved unpopular, however, and such plans were soon abandoned.

By way of illustration, beginning in about 1948, an acute labor shortage[3] was felt in the British coal-mining industry, which situation threatened to hamper the production of other industries dependent upon coal for fuel. In 1951, a scheme for the employment of 6,000 Italian workers was agreed upon, but even this modest plan ended in abrupt failure, largely because of opposition from local trade unions. Some 1,500 miners who had actually entered the country were returned to Italy without ever having entered the mines. The British experience illustrates the difficulty frequently encountered in transferring labor between countries. It is no easy task to dispel long-standing fears of competition from foreign labor,

[2] UN, *Economic Survey of Europe Since the War*, Geneva, 1953, p. 235.

[3] Some have maintained that the labor shortage was brought on by the lack of sufficient acceptable family housing in the affected localities, rather than by an overall shortage of workers.

particularly when a country has experienced mass unemployment in its recent history.[4]

The distribution and utilization of capital within Europe also poses a problem. In general, the countries of northeastern Europe are relatively well off, capital-wise, and are also relatively well developed, whereas the countries of southern and southeastern Europe are both relatively short of domestic capital and relatively underdeveloped. If capital were perfectly mobile and risks were even, a net movement of substantial size could logically be expected to occur from the former to the latter. In practice, however, private capital movements within Europe have long been hampered by various impediments (not least of which is exchange control), and intergovernmental lending has been negligible.

The long-standing maldistribution in capital supplies did not appear particularly important during the years when all the countries were recipients of large-scale United States economic aid. As the postwar period progressed, however, the hard fact was realized that the cessation of capital imports from the United States would, in the absence of intra-European capital movements, compel each country to limit its domestic investments to the volume of its own domestic savings, the effect of which would be to widen further the gulf between the more developed and the less developed countries.

Nationalism and other factors considered, there appears to be little immediate hope for a substantially greater volume of intra-European lending, particularly via governments, since each government is prone to regard its capital supplies as something less than its own needs, irrespective of the particular country's status relative to other countries. The most that can probably be hoped for is some degree of coordination in the direction and pace of the various independent investment programs.

The Customs Union Issue

During the early postwar years, the formation of a European customs union was viewed as an important part of the answer to the longer-term

[4] Efforts to induce a population exodus *from* Europe met with somewhat greater success. In 1951 the United States sponsored a Conference on Migration, meeting at Brussels, at which a Provisional Intergovernmental Committee for the Movement of Migrants from Europe (PICMME) was formed. The organization began operations early in 1952, and by the year's end a total of twenty-one countries had joined. The overall objective of PICMME was to assist Europeans in their efforts to migrate to other parts of the world. Operating on a relatively small budget (e.g., $41.4 million in 1952), PICMME was instrumental during its first year in moving some 100,000 persons from Europe. Most migrants were from Austria, Germany, Greece, Italy-Trieste, and the Netherlands, and the great majority of them moved to Australia, Canada, Israel, Latin America, New Zealand, and the United States.

question of developing intra-European trade. The idea of a customs union was supported by United States opinion and, in 1947, largely in response to American prodding, a European Customs Union Study Group was created. After examining the matter, the conclusion was reached that the proposal for a customs union embracing all the countries of Western Europe was utopian, and formal negotiations for its formation were never begun. Two major obstacles were encountered. First, quantitative import restrictions, not tariffs, constituted the major impediment to intra-European commodity trade at the time. Under the circumstances, the lowering of tariffs would have represented merely a half-measure in freeing intra-European trade of restraints. Second, attempts to bring about a relocation of production through freer commodity trade, without also allowing labor and capital to move freely between countries, were certain to create serious economic disruptions in some countries. Individual countries were unwilling to subject themselves to such hazards.

Proposals for customs unions on a smaller scale encountered much the same difficulties. Negotiations among the Scandinavian countries, between France and Italy, and between Greece and Turkey, all ended in stalemate. *Benelux*, the union of Belgium, the Netherlands, and Luxembourg, stands out as the only instance in postwar Europe in which negotiations for a customs union led to practical results. Negotiations among the three powers dated from 1943,[5] and were initiated in anticipation of the common problem of postwar reconstruction. The initial proposal aimed at a close economic union, without trade barriers and with free movements of capital and labor. In contrast, the plan put into effect in 1948 merely abolished customs duties between the three countries and established a common tariff upon imports from outside the customs area. The elimination of tariff barriers between the three countries proved not too meaningful, since the quantitative restrictions which remained constituted a far more serious impediment to trade. In 1949, however, all quantitative restrictions except those upon most agricultural products were also abolished.

The major difficulty encountered in removing the remaining obstacles to free trade within Benelux rests upon the different conditions of agriculture in Belgium and the Netherlands and, more generally, upon the differences in monetary and fiscal policies which have prevented an alignment of wages and prices in the two countries. Belgium's costs tend to be higher than those of the Netherlands, especially as related to agricultural output. Full economic union is therefore vigorously resisted by

[5] Belgium and Luxembourg joined in a customs union in 1922.

specific Belgian interests, largely the agricultural interests and those sympathetic to the latter.

"Integration by Sector"

The shortcomings of efforts to achieve economic integration through customs unions had become fairly evident by 1950. Most countries simply were not prepared to make the across-the-board concessions required by full-fledged participation in a customs union. Realization of this fact induced the proponents of economic integration to shift their emphasis from an "overall" approach to an "industry-by-industry" approach. The latter approach, commonly referred to as "integration by sector," has figured importantly in plans for the coal and steel industries and for the agricultural industry.

1. **Integration in Coal and Steel.** The major experiment in unification by sector occurred in the coal and steel industries. The need for integration in coal and steel was clear-cut since rigid adherence to independent and uncoordinated policies patterned along national lines gave rise to an irrational utilization of natural resources. Problems inherent in integration, moreover, appeared to be at a minimum in their case. Production was concentrated in a comparatively small area and number of units and, in spite of the "key" position of the industries, only 2 to 3 per cent of the labor force of the interested countries was directly involved.

Plans for the pooling of effort in coal and steel were contained in the so-called *Schuman Plan*, put forth in 1950 by Robert Schuman, then Foreign Minister of France. This proposal led to the formation of the Coal and Steel Community, membership consisting of western Germany, France and the Saar, Belgium, Luxembourg, the Netherlands, and Italy. According to terms of the international agreement concluded, a supranational authority (called the "High Authority") was established and was entrusted with *limited* powers to coordinate production, marketing, and investment in the industries.

Formation of the Coal and Steel Community held interesting political and economic implications. From a political standpoint, sovereign countries, including France and Germany, long antagonistic toward one another, accepted the general principle of international control over industries essential for the conduct of modern warfare. From an economic standpoint, the agreement had the merit of conceivably promoting a more economic utilization of resources than likely to prevail under a system of completely independent and uncoordinated national policies. Establishment of the Community, however, immediately raised the old issue of

international cartels. It has been widely feared that the vesting of control in the hands of a single authority simply makes it easier for international cartels to arise and to practice price fixing, the division of markets, the suppression of investment and technology, and the various other trade restrictions at which they have proven themselves so adept in the past.

2. Integration in Agriculture. During the postwar years, various so-called *"green pool" plans* have been put forward in an attempt to promote a gradual unification of agricultural markets in Western Europe. The typical plan has envisaged the creation of an international body, somewhat along the lines of the Coal and Steel Community, which would gradually remove the barriers to trade in a smaller or greater number of agricultural products, while taking appropriate measures to avoid or mitigate social and economic disturbances resulting from such action. The gains allegedly to be derived from integration in agriculture arise from the better utilization of soil and manpower which the process would promote, and the greater degree of self-sufficiency in food within Europe which, if achieved, would reduce the latter's dependence upon imports payable in scarce currencies.

Despite the many proposals, little or no tangible progress has been made. Vested interests within the various countries have been prone to resist change, and governments, too, have been unwilling to forego a semblance of national self-sufficiency in agriculture.

The European Payments Union

In 1947, intra-European trade stood at 55 per cent of its 1938 level. The reduced volume of trade was attributable not only to the relatively low level of production, but also to the absence of a workable payments system within Europe. We may briefly review how the latter situation arose, and then proceed to examine what was eventually done about it.

At the end of the war the countries of Western Europe were seriously short of dollars (and gold). The natural tendency for each, therefore, was to restrict its purchases from the others so as to avoid the loss of scarce reserves. In general, each deficit country was inclined to reduce its purchases from every other country to the level of its sales to each such country. The effect of such generalized restrictions was to hold down the total volume of trade, but without thereby alleviating the general dollar problem. Moreover, the restrictions upon trade tended to encourage uneconomic investments in facilities for the domestic production of commodities normally imported.

In an attempt to free trade from the bilateral forms it had assumed,

the members of OEEC developed, with the help of the United States, a regional payments scheme in 1948 (amended and extended in 1949) to provide for multilateral clearing of bilateral surpluses and deficits among the European countries. These arrangements proved clumsy, however, and were replaced in July, 1950, by a more refined system, the European Payments Union (EPU).

Essentially, EPU put into operation the clearing-house technique in order to promote multilateralism within Europe. Briefly, EPU works as follows. Each of the seventeen member countries[6] has a quota, the size of which is related to the member's relative importance in intra-European trade in 1949. Quotas total the equivalent of $4,155 million.[7] Among other things, the size of a country's quota determines its potential cumulative "drawing rights." The central bank of each member is periodically (usually each month) to inform the Bank of International Settlements, located in Switzerland, of its claims (arising out of all current transactions by its residents) against the central banks of each of the other members. Their respective debits and credits are then offset against one another, and any uncleared balances are treated as claims upon or liabilities to EPU.

Settlement of these balances occurs in accordance with a formula (Table 31). According to the revised schedule introduced on July 1, 1952,

Table 31

Settlement of Member's Debit and Credit Balances with EPU

(revised schedule, effective July 1, 1952; in per cent of member's quota)

Per cent of quota of cumulative surplus or deficit	For Cumulative Debtors		For Cumulative Creditors	
	Use of Credit	Payments of gold [1]	Use of Credit	Payments of gold [1]
First 10%	100%	0%	100%	0%
Second 10	80	20	100	0
Second 20	70	30	50	50
Third 20	60	40	50	50
Fourth 10	50	50	50	50
Fifth 20	30	70	50	50

[1] Obligations to pay gold may be discharged in U. S. dollars.

Source: IMF, *International Financial Statistics,* Washington, June, 1954, p. 13.

[6] Austria, Belgium-Luxembourg, Denmark, France, Germany, Greece, Iceland, Italy, Netherlands, Norway, Portugal, Sweden, Switzerland, Turkey, and the United Kingdom and Ireland.

[7] IMF, *International Financial Statistics,* Washington, May, 1954, p. 13.

debit balances up to 10 per cent of a member's quota are settled through use of EPU credit. Whenever cumulative debits exceed this amount, the member is obliged to begin payments in gold[8] (or in United States dollars) to EPU. Such payments become progressively larger and the use of credit becomes progressively less as the size of the member's cumulative deficit with EPU is increased. Credit balances up to 20 per cent of a member's quota are payable in EPU credit, while credit balances in excess of this amount must be settled one-half through payments of gold (or dollars) by EPU to the creditor and one-half by an extension of credit to EPU. All cumulative deficits or surpluses in excess of the assigned quota must be settled in gold (or dollars).

Three aspects of EPU appear particularly noteworthy. First, EPU offers temporary assistance to members experiencing balance-of-payments deficits vis-à-vis other EPU members. Such assistance, although limited in amount and duration, is provided through EPU's use of the overdraft principle.

Second, the operation of EPU tends to force both deficit and surplus countries to undertake adjustments. The incentive for such adjustments by deficit countries stems from the loss of gold which confronts persistent debtors, and upon an interest charge scaled to rise as debts to EPU continue to be outstanding. The incentive for adjustments by surplus countries stems largely from the fact that when they build up surpluses they are paid only partly in gold or dollars.

Third, and most important, *EPU promotes multilateralism on a regional basis* within Europe; the approach is regional, not world-wide. EPU provides the machinery through which European currencies are made convertible in terms of one another (up to a point), irrespective of their status relative to the dollar area. EPU does not deal with Europe's dollar shortage, except in so far as greater multilateralism within Europe might serve to lessen dependence upon dollar-area imports or might serve indirectly to improve trading relationships with the dollar area or with third countries acquiring dollar surpluses.

A Criticism of Economic Integration

Proponents of economic integration frequently maintain that the removal of trade and payments impediments can best proceed if approached

[8] Since most members held little gold at the time EPU was formed, some of them probably would have preferred to proceed with bilateralism rather than to risk a liability in terms of gold in event of pronounced balance-of-payments deficits. In the interests of speeding the return of multilateralism, even if only on a regional basis, ECA provided $350 million which might be used to reimburse members experiencing a severe loss of gold during initial phases of the clearing program.

on a regional basis. As they view it, the removal of impediments on a global basis may be too ambitious an approach to garner widespread support; therefore, they argue, a start should be made on a regional basis, and the area of coverage should gradually be expanded thereafter. On the other hand, critics of economic integration frequently point out that the removal of impediments on a regional basis is not a first step in their removal on a global basis. They feel that the proponents of economic integration, in so maintaining, either fail to understand or deliberately misrepresent the true case.

By way of illustrating the views of these critics, we may note that closer economic union between a few countries frequently occurs only after the erection of greater barriers between them (as a group) and the rest of the world. For example, when Countries A and B form a customs union, they lower tariffs on one another's goods, but they impose a common (and sometimes increased) tariff on competitive imports from, say Country C, outside the customs area. Thus, prior to formation of a customs union, consumers in A, where no coal is produced, may obtain their coal from C, a relatively low-cost producer; after formation of a customs union, the higher tariff wall around the customs area may serve to divert A's purchases of coal from C to B, the latter a relatively high-cost producer.

As shown in the illustration, closer economic union between a small group of countries may merely constitute a cover-up for discrimination against trade with the world at large. Instead of being a first step in the freeing of trade on a global basis, the regional approach may simply constitute a protectionist device to insulate a relatively few countries against the rest of the world. As stated by one authority, writing about customs unions, the regional approach

> . . . is only a partial, uncertain, and otherwise imperfect means of doing what world-wide non-discriminatory reduction of trade barriers can do more fully, more certainly, and more equitably, and it will be a sad outcome of confused thinking on our part if we in effect abandon our pursuit of the greater economic goal because of our fresh, and romantic, infatuation with the lesser goal.[9]

Economic Integration: The Record

Did the attempts made at economic integration meet with success in bringing about an increase in the volume of intra-European trade? An absolutely conclusive answer is difficult to arrive at, since the volume

[9] J. Viner, *The Customs Union Issue* (New York: Carnegie Endowment for International Peace, 1950), p. 135.

of trade is dependent upon numerous factors, economic integration (or the lack of it) being only one of them. Nevertheless, available information allows us to shed some light on the matter.

During and immediately following World War II, the volume of intra-European trade was at a relatively low level. In 1948, for example, the index of the dollar volume of intra-European trade (unadjusted for price changes) stood at 164 (1938=100), as compared to 256 for total world trade. After 1948, however, the dollar volume of intra-European trade rose more rapidly than did the volume of world trade; the indices of intra-European trade (1948=100) were 166 in 1951 and 167 in 1953, as compared to 142 and 139, respectively, for total world trade in these years.[10]

The foregoing statistics are not particularly meaningful unless viewed against the volume of goods available for trading. As a rough measure of the volume of goods, the index of industrial production for Europe was 100 in 1948 (1938=100), as compared to 143 for the world as a whole. Following 1948, the rate of increase in production in Europe exceeded that of the world as a whole; the indices of industrial production for Europe (1948=100) were 136 in 1951 and 146 in 1953, as compared to 125 and 137, respectively, for the world as a whole in these years.[11]

Comparing the two sets of data, we observe that between 1948 and 1953 the volume of industrial production in Europe and in the world as a whole, respectively, rose by roughly similar proportions, but during the same years the volume of intra-European trade rose at a considerably more rapid pace than did world trade.

MONETARY REFORM

A second approach to the solution of Western Europe's balance-of-payments problem is through monetary reform, i.e., through disinflation plus exchange depreciation.

As we have previously observed, the countries of Western Europe came out of World War II with a great deal of inflation. Price levels in the various countries had risen by varying amounts during the war years, but everywhere the increase far exceeded that in the United States. Considering what Europe had endured during the war, however, the resultant inflation was hardly unexpected.

[10] Data from UN, *Monthly Bulletin of Statistics*, New York, May, 1954, pp. xvi-xvii, and from UN Statistical Office. All data exclude the U.S.S.R. and its satellites.

[11] UN, *Monthly Bulletin of Statistics*, New York, July, 1954, p. xvi. All data exclude the U.S.S.R. and its satellites.

Following the war, the countries of Western Europe did not embark upon policies of disinflation. Rather, the general practice was to initiate domestic monetary and fiscal policies which could have little effect other than to intensify inflationary pressure. There were reasons, of course, why the countries chose to initiate such policies. First, the countries sought to reconstruct their economies in rapid fashion. Accordingly, manpower and resources were poured into the reconstruction effort, to a considerable extent at the expense of production for present consumption or exportation. Second, the countries sought to promote capital projects which might help give rise in the reasonably near future to a level of per-capita income above that of prewar days. In a sense, reconstruction was thus coupled with development. Third, the countries sought to provide social benefits not regarded within the scope of government in prewar days. A case in point was the program initiated by the British socialist government to provide its population with social benefits on a "cradle-to-the-grave" basis. Fourth, the countries were prone to believe that a postwar depression was a definite threat. Under the circumstances, further inflation appeared far more palatable than anything even faintly resembling deflation.

Whatever the particular motivation, or motivations, guiding the countries in the determination of their policies, the general situation was that inflationary policies were widespread. In country after country of Western Europe, the official policy was unbalanced budgets, "easy" money, and ambitious expenditure programs. The end result was an impairment of Western Europe's *capacity* and *ability* to export. First, the magnitude of the domestic investment programs tended to lower the capacity of the Western European countries to undertake exports. The manpower and resources which might have been used to produce goods for export were used instead in connection with the domestic investment programs. Second, the high and rising prices in consequence of the particular domestic policies tended to lower Western Europe's ability to sell in foreign markets in competition with foreign suppliers.

The origin and nature of the postwar inflation problem came, in some instances, to be recognized fairly early. For example, Prime Minister Attlee, in an address to the House of Commons during the midst of the "crisis of 1947," said as follows: "Maybe the Government has tried to do too much."[12] In any event, in Great Britain and elsewhere the intensity of some of the domestic monetary and fiscal policies was slackened; and, with the beginning of Marshall Plan, Western Europe was definitely given

[12] Cited by R. Harrod, *Are These Hardships Necessary?* (London: Rupert Hart-Davis, 1947), p. 23.

a breathing spell. By 1949, inflationary pressure in Western Europe, with rare exception, was brought under control.

The most notable single attempt to do something positive to restore Western Europe's ability to sell in non-European markets, particularly in the dollar area, came in the currency devaluations of 1949. As we have previously observed, the postwar par values assigned the currencies of some countries, though approved by the IMF, were at overvalued levels; included in this category were some currencies of Western Europe. The effect of overvaluation was to encourage imports from those countries whose currencies were relatively undervalued (e.g., the United States) and to discourage exports to them. This fact, plus domestic price increases subsequent to the approval of the initial par values, created a situation of balance-of-payments deficits. Because of the "dollar gap" in her balance of payments, Great Britain (in September, 1949) devalued the pound sterling by 30.5 per cent, and in succeeding days twenty-eight additional countries (both in Europe and elsewhere) also devalued by varying amounts, most of them by an amount similar to that of Great Britain.

The avowed purpose of the wave of devaluations was to alter the trading relationships between a relatively large number of non-dollar countries and the dollar area, and in this manner to allow the former to cope with their dollar shortages. (Since most of the countries devaluing did so by an approximately similar amount, trading relationships between these countries remained substantially unchanged.) The lessening or elimination of the dollar shortage was expected to follow from the effect of devaluation in discouraging imports from and in encouraging exports to the non-devaluing countries. Whether devaluation could serve to eliminate the dollar shortage, however, depended fundamentally upon the elasticities of supply and demand for the foreign-trade items themselves.

The magnitude of the dollar shortage did diminish in the year following the devaluations (Fig. 12, Chapter 21). Upon the outbreak of the Korean conflict, however, inflationary pressures again reappeared, and Western Europe's balance-of-payments deficits also again began to mount. Western Europe's difficulties this time were attributable mainly to (1) the rising cost of raw-material imports, and (2) the demands placed upon the domestic economies in consequence of military outlays. The result has been the continuation of balance-of-payments deficits in a number of Western European countries during and after the Korean conflict.

It is significant that not all the countries of Western Europe continued to experience balance-of-payments deficits of equal intensity. Three countries — Denmark, western Germany, and the Netherlands — have suc-

ceeded in markedly improving their balance-of-payments positions. The fact that these countries have pursued relatively "tight" money policies lends credence to the belief that inappropriate monetary policies have been a factor in Western Europe's balance-of-payments difficulties.

STRUCTURAL READJUSTMENT

A third approach to the solution of Western Europe's balance-of-payments problem is through structural readjustment (i.e., through a re-alignment of trade). As we have already observed (Table 30, Chapter 21), imports of Western Europe from Eastern Europe and the non-dollar countries of Latin America decreased, postwar as compared to prewar, while exports to affiliated overseas countries increased. The elimination of the dollar shortage, however, requires a quite different pattern of trade: Western Europe must acquire more of her imports from non-dollar countries and must increase her exports to the dollar area or to third countries earning a dollar surplus.

There is some question as to just how far Western Europe may proceed in the realignment of her trade. After all, it takes two to trade; without minimizing Western Europe's responsibility in the matter, it is only reasonable to point out that her failure to promote successfully a realignment of trade heretofore is attributable, at least in part, to factors entirely outside her control. However, let us examine the various directions realignment, if undertaken, may conceivably take:

(1) To what extent may Western Europe shift her imports from the dollar area to non-dollar countries? The answer is that whatever success is achieved in this direction (at least under circumstances similar to those of the first decade following World War II) must occur in spite of fundamental obstacles. The plain fact is that the dollar area has goods of the type and in the quantity needed by Western Europe to a much greater extent than is true of the non-dollar countries. Following the war, the industrial-type imports needed by Western Europe were obtainable only from the dollar area, and in the absence of pronounced economic development elsewhere this largely continues to be true (in so far as any industrial imports continue to be required). Western Europe's long-run import needs, however, are largely for raw materials and foodstuffs. A great proportion of these, too, are more readily obtainable from the dollar area than from elsewhere. Eastern Europe, once a large-scale supplier of raw materials and foodstuffs to Western Europe, has been largely removed as a source of supply, in part because of political developments, and in part because of Eastern Europe's own plans for economic develop-

ment which have the effect of de-emphasizing the latter's role as an exporter of raw materials and foodstuffs. Moreover, the non-dollar countries with which Western Europe is free to trade do not possess adequate supplies of the particular raw materials and foodstuffs essential to Western Europe. The result is that the dependence of Western Europe upon imports from the dollar area is likely to remain relatively great.

(2) To what extent may Western Europe increase her exports to third countries (i.e., non-dollar countries not affiliated with Western Europe) in order thereby to acquire dollars? The prospects for success in this direction are dimmed by the fact that the dollar shortage extends also to many of the third countries. To the extent, however, that dollars do accrue to the third countries, there is always the possibility that Western Europe *could* earn more dollars if she were to make a concerted effort to supply goods more directly competitive in quality and price with American goods. The fact that third countries, as evidenced by past action, prefer to spend their dollar earnings directly in the United States, rather than in trade with the countries of Europe, lends credence to the view that the countries of Europe have not done all that they might in this connection.

(3) To what extent may Western Europe increase her exports directly to the dollar area? Two fundamental obstacles limit success in this direction. First, the exports of the United States constitute formidable competition for Western Europe's exports in the dollar-area countries other than the United States. Because of the relative proximity of the United States to the latter countries (mainly Western Hemisphere countries), and because of a variety of other economic and political considerations, the United States holds an "edge" over Western Europe in the sale of a wide range of commodities to these countries. Second, as for the United States market itself, Western Europe's exporters are for the greater part either entirely or partially excluded by virtue of various import restrictions, or are unable to compete successfully in it.

All factors considered, mass sales in the American market appear to offer the most important and most direct single line of attack upon Western Europe's dollar shortage. Thus, the American market, in an aggregative sense, is the world's largest. Roughly one-half the national income produced in the world arises in the United States. The fact that complete success has not characterized Western Europe's past efforts to earn dollars through sales made directly in the United States does not necessarily mean that greater success cannot be achieved in the future. Therefore, we may direct our attention to some of the specific courses of action

which, if put into effect, may conceivably enable Western Europe to increase her sales in the American market.

The American Market

What can the countries of Western Europe do to increase their sales in the United States? First, if producers are to sell in the American market, they must be prepared to offer goods for which there is substantial demand. Past experience indicates, however, that European-produced goods are either too similar to American goods (while higher priced) to capture a market, or consist of specialty goods for which the demand is both relatively small and inelastic. For example, European automobile producers have been unable to capture a mass market in the United States, and would not likely do so even in event all tariffs were removed. Sales are limited largely to luxury or sports models, which sell in part precisely because they are not commonplace. Similarly, European textile sales in the United States are restricted largely to high-quality goods of a type not produced in this country. The general situation is that Europe has been unable thus far to compete successfully in the United States market in mass-produced goods, and has been unable to promote volume sales in specialty goods. In short, European production is geared to compete, not in the United States market as a whole, but merely in a small segment of it. European producers need to re-examine the nature of their production, therefore, with a view toward developing volume exports in lines in which a comparative advantage exists or is capable of being developed.

Second, producers must be able to offer their wares at competitive prices. A first prerequisite therefore is a further lowering of production costs. Some possibilities include the following: (1) a more widespread adoption of new and improved equipment and production processes, (2) the pursuit of non-inflationary domestic economic policies, and (3) greater economic integration.

Third, producers must actively push their foreign sales. It is not enough to produce an article and then to wait for it to sell itself. If past practice is any criterion, there is something to be said for the adoption of more vigorous selling methods, such as widespread advertising, the use of more attractive packaging, and provision for follow-up servicing when such is applicable.

What can the United States do to assist the European countries to promote their export sales? First, the United States might consider the possibilities of giving European producers freer access to its markets. To the extent that tariffs and other import restrictions impede imports,

the reduction or elimination of these barriers may enable added foreign sales to be made in the American market. Also, elimination of the uncertainty which clouds the whole tariff situation in the United States, particularly as it relates to the "escape clause," may serve to encourage European producers to undertake the investments and other heavy expenses which are, for many products, essential in order to enter, or to expand sales in, the American market. (The restrictiveness of United States tariffs upon imports has been discussed at length in Chapter 14.)

Second, the United States can make a great contribution to European recovery, and indeed to world morale, if it maintains prosperity at home, and if it is able, in fact, to impress upon other countries its serious intent to maintain prosperity on a long-run basis. Unfortunately, there is present in Europe an ever-lingering fear that the United States will sooner or later fall victim to depression. It is feared that in such event the United States will greatly reduce its volume of importation,[13] not only in consequence of diminished domestic purchasing power, but also because of a sudden reimposition of those protectionist barriers which have gradually been reduced during recent decades. As long as such doubts are widely entertained, there is little hope that European producers will undertake the investments essential for successful competition in the American market.

Trade with the Soviet-Bloc Countries

The fact that the countries of Western Europe *may* not succeed in markedly increasing their exports to the dollar area or to third countries earning dollar surpluses serves to raise another question: What are the chances for greater trade between Western Europe and Eastern Europe (i.e., with the U.S.S.R. and the satellite countries which fringe it to the west)? Such trade, if it were to occur, would not earn dollars for Western Europe, but it could very well serve to lessen Western Europe's need to trade with the dollar area.

Prior to World War II, a flourishing trade existed between the countries of Western Europe and those of Eastern Europe, especially with the eastern countries other than the U.S.S.R. This trade was facilitated by the complementary nature of the economies; the western countries were heavily industrialized, while the eastern countries were largely agricultural. Following the war, a schism arose between East and West.

[13] A recent UN report estimated that a recession no more severe than that experienced in the United States between 1937 and 1938 might well entail, at the current level of United States imports, a loss of dollar receipts by other countries of some $10 billion over the whole period of recession and recovery. See UN, *Economic Survey of Europe Since the War,* Geneva, 1953, p. 131.

While the schism was fundamentally political in nature, it also had its economic aspects. Most important, the eastern economies became closely tied to the Soviet economy, and trade with the West declined to a trickle.

Beginning in 1953, but more particularly in 1954, the Soviet Union launched what has been described as an aggressive "trade offensive" aimed at the West. While the United States has taken a rather dim view of trade with the Soviet Union (or with any part of the Soviet bloc), the trading and payments difficulties of Western Europe, and especially of Great Britain, have been sufficiently grave to arouse considerable interest in the potentialities of trade with Eastern Europe.

It goes almost without saying that if trade is to occur between Western Europe and Eastern Europe, there must be something on both sides to trade. The industrial products of Western Europe, of course, stand a good chance of being desired (at least under present-day circumstances) in the "goods hungry" countries of Eastern Europe. The more important question concerns the availability of goods in Eastern Europe which might be desired in Western Europe. Accordingly, we may turn to an examination of this question.

First, is the productive capacity of Eastern Europe sufficiently great to sustain large-scale trade with Western Europe? The productive capacity of Eastern Europe suffered heavy damage during World War II, perhaps even greater damage than sustained in Western Europe. Production during the early postwar period, therefore, was decidedly below that of prewar. In the Soviet Union, extraordinary effort was expended under the Fourth Five-Year Plan (1946-50) to restore productive capacity and output. Reconstruction required that a relatively high proportion of current national income be reinvested, and consumption was therefore of necessity held at a relatively low level. Rapid progress was made and, according to a report of the Economic Commission for Europe, the Soviet Union had by 1950 recovered to substantially its prewar position. The report stated as follows:

> The progress of Soviet production was very substantial and . . . [by 1950] the national income was well above its pre-war level. . . . Heavy industry substantially exceded its goal under the Fourth Five-year Plan (1946-1950), and was the major factor in bringing about the rise in national income. War losses in agriculture had been particularly heavy and the pre-war level of output was only slightly exceeded in 1950. . . . The bulk of the increase in national income over pre-war was devoted to investment and defense, while very little of it went to increase consumption. By 1950, consumption standards had returned to the pre-war level. . . . Although some slowing-down in the rise in output of Soviet industry was inevitable with the close of the period of rapid reconstruction, at the

> end of the Fourth Five-year Plan the further industrialization of the Soviet Union continued at a rate surpassing that in any western European country.[14]

The Fifth Five-Year Plan (1951-55) established as its goal a further increase of 60 per cent in national income, to be achieved through an increase of 70 per cent in industrial output and of 40 to 50 per cent in agricultural output.[15]

In the satellite countries, the postwar era may be divided roughly into two phases. The early postwar years, extending to 1949 or 1950 in most of the countries, were given over to the reconstruction of the economies. Thereafter, the various governments introduced national economic plans, largely patterned after the Soviet Five-Year Plans; the purported purpose of these plans was to facilitate the rapid achievement of more balanced and powerful economies. Discernible effects have included the growth of industrial capacity, the deliberate retardation of growth in consumption, and the development of closer economic ties with the Soviet Union (along with lessened trade with the West).[16]

In short, there is considerable evidence that the countries of Eastern Europe have been able in the first decade since World War II to raise their productive capacities well above prewar levels. A second question, however, is in order: Does Eastern Europe have available exports in the quantity and of the type desired by Western Europe? The mere existence of productive capacity, or of a relatively high level of output, does not necessarily mean that a basis for exportation exists. In the case of the countries of Eastern Europe (both the Soviet Union and the satellite countries) there is reason to believe that the long-run basis for trade with Western Europe is not good. First, the countries simply do not possess, and never have possessed, many of the raw materials and foodstuffs required by Western Europe (e.g., products of tropical origin). Second, the countries are committed at present, and in the foreseeable future, to the utilization at home (for investment and consumption) of virtually all domestic production. Third, the countries are committed to the promotion of relative self-sufficiency (as viewed from the standpoint of the Soviet bloc as a whole). Fourth, and most important, the national economic plans of all the countries are designed to promote the industrialization of the countries concerned. The effect of such programs, if long continued, is to make the output of the economies of Eastern Europe ever less complementary with that of the Western European countries, thereby gradu-

[14] UN, *Economic Survey of Europe Since the War*, Geneva, 1953, p. 38.
[15] *Ibid.*
[16] See *Ibid.*, Chap. 3.

ally, over the years, removing some of the basis for trade which once prevailed.

The conclusion which follows from the foregoing analysis is that Western Europe can more readily sell to Eastern Europe than buy from her. Sources of supply being what they are, Western Europe can do little but to continue to be heavily dependent upon purchases in the dollar area. And, significantly, a surplus of foreign exchange earned in exportation to Eastern Europe does not provide (either now, or in the foreseeable future) a basis of payment for imports acquired from the dollar area.

SUMMARY

In addition to, or in connection with, Marshall Plan aid, three basic courses of action have been proposed as possible ways to eliminate or diminish Western Europe's dollar shortage: (1) economic integration, (2) monetary reform, and (3) structural readjustment (i.e., a realignment of trade).

Economic integration — the removal of artificial barriers to trade and payments — was proposed on grounds that it might (*a*) improve productive efficiency within Western Europe, thereby improving the region's competitive position in foreign markets, and (*b*) replace some imports from the dollar area with trade within Western Europe itself.

Some persons proposed monetary reforms on grounds that inflation, fed by the pursuit of particular domestic monetary and fiscal policies, tended to impair Western Europe's ability to compete in non-European markets.

Structural readjustment (i.e., a realignment of trade) was proposed on grounds that the dollar shortage might be eliminated if imports from the dollar area could be reduced or if exports to the dollar area or to third countries having dollar surpluses could be increased.

SELECTED REFERENCES

°Balogh, T., *The Dollar Crisis: Causes and Cure.* Oxford: Basil Blackwell & Mott, Ltd., 1949.

Crosland, C. A. R., *Britain's Economic Problem.* London: Jonathan Cape, Ltd., 1953.

°Diebold, W., Jr., *Trade and Payments in Western Europe.* New York: Harper & Brothers, 1952.

°Ellis, H. S., *The Economics of Freedom.* New York: Council on Foreign Relations, 1950, Part I.

Haberler, G., "Dollar Shortage?," in S. E. Harris (ed.), *Foreign Economic Policy for the United States.* Cambridge: Harvard University Press, 1948.

°———, "Reflections of the Future of the Bretton Woods System," *American Economic Review* (Papers and Proceedings), May, 1953.

°Harris, S. E., *The European Recovery Program.* Cambridge: Harvard University Press, 1948.

———, "Devaluation of the Pound Sterling," *Harvard Business Review,* November, 1949.

Harrod, R. F., "The Dollar-Sterling Problem," *International Affairs,* April, 1950.

Henderson, H., "The Moral of the British Crisis," *Review of Economics and Statistics,* November, 1949.

°Keynes, J. M., "The Balance of Payments of the United States," *Economic Journal,* June, 1946.

°Kindleberger, C. P., *The Dollar Shortage.* New York: John Wiley & Sons, Inc., 1950.

Smithies, A., "European Unification and the Dollar Problem," *Quarterly Journal of Economics,* May, 1950.

°United Nations, *Economic Survey of Europe in 1948,* Geneva, 1949. (Also issues for 1950, 1951, 1952.)

°———, *Economic Survey of Europe Since the War,* Geneva, 1953.

°Williams, J. H., *Economic Stability in a Changing World.* New York: Oxford University Press, 1953, Part II.

Part V

Policy Determination

A country is obliged in practice to formulate a foreign-trade policy for itself. In formulating such a policy, what factors should properly be taken into account, and what objectives should be regarded as appropriate? This final section treats the matter of policy determination at the national level, and the matter of inter-country conflicts in consequence of the countries' adherence to independent national policies.

23

Conflicts of National Interest

A BASIC FUNCTION of a government is to promote the national self-interest of the designated political area over which it has jurisdiction. Notions as to how national self-interest may best be promoted differ both over time and as between countries at a given time. Ordinarily, however, such notions merely reflect what is believed to be a rational approach in view of a particular *environment*. The basic environment within which an individual government has to operate varies widely: some countries are developed, while others are underdeveloped; some countries are relatively rich in resources, while others are relatively poor; some countries are relatively happy with their status quo within the context of the world economy, while others feel that change can only serve to improve their lot; and some countries feel weak and defenseless alongside their more powerful neighbors, while others feel sufficiently strong to more than "hold their own" under most any conceivable circumstances. The important fact, however, is that governments react to the particular environment within which they operate; the policies which they initiate and pursue are in the nature of answers to particular problems posed by particular environmental factors. In short, because governments are confronted by varying environments, the policies initiated and pursued by them also vary. It is logical to expect that some of these policies will

tend to work at cross purposes, if not indeed in some instances to clash violently.

This chapter treats some of the basic conflicts of national interest found in the foreign-trade field today, and indicates why and how agreement along international lines becomes difficult under the circumstances.

MAJOR NATIONAL POLICIES

As we look about us in the world today, we readily observe that countries, as viewed by the economic positions they occupy and the national aspirations they cling to, fall into four broad categories. These are as follows: (1) the Soviet-bloc countries, (2) the underdeveloped countries, (3) the countries of Western Europe, and (4) the United States. The categories are not in all instances mutually exclusive, e.g., some of the Soviet bloc is also underdeveloped. Viewed in a broad, overall sense, however, division along the lines chosen is economically meaningful for purposes of analyzing the problems of the world of today. We may, therefore, briefly examine each of the four categories in order to determine the nature of its motivating forces in the formulation of policy.

The Soviet Bloc

An outstanding characteristic of the present regime in the U.S.S.R. is its apparent belief that it exists in a world for the greater part hostile to it. There is ample evidence that Soviet leaders have long thought of the world as being divided into two camps: East and West. Adherence to this notion has served to color virtually every basic decision made in recent years. The prevailing attitude has also left its imprint upon the course of foreign trade. In the latter field, two major policies have evolved.

First, the Soviet Union pursues a policy of relative economic isolation, a policy adopted in part for reasons of military self-sufficiency. Foreign trade accounts for a relatively small portion of total productive effort. Because of the country's large land area and diverse resources, foreign trade cannot rightly be expected to loom as large in the Soviet economy as in, say, the smaller and more specialized economies of Western Europe. Viewed in retrospect, however, it is apparent that the Soviet Union did not seek to promote a large volume of foreign trade; rather, there is some evidence that the volume was deliberately held down. For example, during the early years of her state-directed economic-development program, the Soviet Union did not to any large extent draw upon foreign countries for economic assistance, but instead placed almost the entire burden upon

the domestic economy, then very poor. This desire to be self-contained largely remains in force even today. It might be added that if the Soviet leaders felt a large volume of foreign trade was not warranted a generation ago when the country was still in the infant stages of economic development, then certainly there is a basis for argument that there is even less urgency for foreign trade today.

Second, such foreign trade as is carried on by the Soviet Union is motivated in large part by political factors. The structure of the Soviet government and economy, of course, lends itself readily to the conduct of trade along political lines. Such politically inspired trade, for the greater part, takes two directions. The major portion of the Soviet Union's foreign trade is with the so-called satellite countries (since World War II). The immediate political objective of the Soviet Union in its trade with the satellites appears to be, first, to draw these countries away from the West to which they were once geared and, second, to tie them more closely to the Soviet economy and thereby to lessen the chance that they may some day defect to the West. The satellite countries, in turn, appear not to have been particularly averse to the development of such a tie with the Soviet Union. Since all have governments which in a sense are "carbon copies" of that of the Soviet Union, it is not illogical to believe that the ideological tie may in itself have been of sufficient strength to support additional ties. There may also be something to the assertion, voiced by various persons, that the peoples of the satellite countries were preconditioned by the events of World War II to the developments which evolved thereafter; to them, anything which bore the label "anti-fascist" did not look too bad. All this, of course, is not to intimate that trade between the Soviet Union and the satellites is not of economic advantage to either, or both, parties. The contention here is simply that whatever economic merit foreign trade may have for either the Soviet Union or the satellites, there exists a political motivation for such trade which, even in the absence of any economic advantages, may warrant its occurrence, as viewed by the Soviet Union.

A lesser portion of the Soviet Union's foreign trade is with the countries of the West, especially the countries of Western Europe. Judging by past performance, this trade is conducted in relatively intermittent and sporadic fashion, leading to the frequent charge in the West that the Soviet Union's immediate objective in this case is to produce disruptive effects, e.g., to "drive a wedge" between the various countries of the West. It is entirely possible that such trade may nevertheless yield economic benefits to the respective trading countries. To the extent, however, that political factors serve to motivate the Soviet Union's actions, some of the

economic benefits of trade which might otherwise accrue to it may be deliberately foregone as a matter of choice.

The Underdeveloped Countries

A second major category of countries consists of the underdeveloped countries. These comprise especially the countries and dependent territories of South and Southeast Asia, Africa, and tropical Latin America, but sometimes the countries of South and Southeast Europe and of Oceania are also included. In general, these countries are raw-material producers, and have per-capita incomes below, and sometimes far below, those prevailing in industrialized countries such as the United States and the countries of Western Europe.

The underdeveloped countries tend to be heavily dependent upon foreign trade, but the peoples of the countries tend to dislike the type of trade they are engaged in. As matters stand, the underdeveloped countries export largely raw materials and import largely manufactures and semi-manufactures. A widely held belief in these countries is that their raw-material production is relatively low-income production (as compared to manufacturing), and that this type of production leads, in turn, to foreign trade in a form which involves "selling cheaply" and "buying dearly." What the peoples of these countries appear to desire is a change in the type of production, preferably through a shift to industrialization (which, for the greater part, is what they have in mind when they use the term "economic development").

The passion for economic development pervades many private and public decisions in the underdeveloped countries. Use of the word "passion" is not entirely without merit in this connection; its use lends emphasis to the fact that some of the clamoring for economic development assumes a form which can hardly be labeled "rational" (if the criteria for evaluation are purely economic). This is not to intimate that there is no need, or grounds, for economic development. A strong case for economic development does exist, but it frequently appears to be of far more modest proportions than what is visualized by some of its more enthusiastic proponents.

Two points of special concern commonly confront the governments of the underdeveloped countries in their attempts to stimulate economic development: (1) the need to avail themselves of foreign capital, and (2) the need to extend the helping hand of tariff protection to "infant" industries. The fact that the underdeveloped countries are tariff-minded serves to turn them against proposals to reduce tariffs all-around on a global basis. While these countries may favor lower tariffs in the "ad-

vanced" countries in which they market their goods, they do not necessarily favor lower tariffs for themselves.

Western Europe

A third major category consists of the countries of Western Europe. These countries are all heavily dependent upon foreign trade, and virtually all of them are very heavily industrialized. The single characteristic perhaps unique of Western Europe, however, concerns the fact that the economic position of the countries, aggregatively speaking, has during recent decades undergone a vast change relative to the rest of the world. Relatively more rapid industrial growth in the American economy, plus the impact of war upon Western Europe, has resulted in a relative deterioration of Western Europe's international economic position. This relative deterioration has been accompanied by (or has been evidenced by) balance-of-payments deficits, largely deficits of dollars.

Because of fairly persistent balance-of-payments deficits (and accompanying external-payments problems), the governments of individual countries of Western Europe, especially the British Government, have gradually come to accept policies and attitudes regarding foreign trade which, they feel, are warranted by the environment within which they find themselves. Specifically, both official and popular opinion have come to hold that (1) the United States, the world's largest single market and the largest potential source of dollar exchange, should act to give foreign exporters freer access to its markets, but that (2) an individual European country, when confronted by chronic balance-of-payments deficits, should have the right to impose import restrictions or to practice trade and currency discrimination in order to promote statistical balance in its balance of payments.

The United States

In a fourth category is the United States. The economy of the United States is the world's largest. The United States currently produces roughly one-half the world's output of goods and services, it is the world's largest exporter and (since 1950) the world's largest importer, and it is the world's largest single source of capital. By virtue of its size and wealth alone, if for no other reasons, the United States is today in an unprecedentedly advantageous position to exert world leadership in economic affairs.

As the leading economic power in the world, the United States should logically be expected (for reasons cited in Chapter 14) to be inclined toward freer trade. There is no shortage of statements by economists and public officials in which this general situation is recognized, e.g., the

slogan "Trade, not Aid" has been bandied about for some time. In practice, however, the policy of the United States appears to be one of concern over the prevalence abroad of import restrictions and discriminatory trade and currency regulations, notwithstanding its own retention of various impediments to freer trade.

In its import policy, the United States has during the past two decades made considerable progress in lowering its trade barriers. Such reductions have not occurred entirely without resistance, and further reductions in the barriers still remaining are vigorously opposed in some quarters. A basic reason for such resistance is that domestic groups are not always willing to submit to the adjustments which then come to be required of them.

Most persons have long been aware of the general reluctance of the United States to allow entry of competitive imports. Far fewer persons, however, have been fully aware of this country's peculiar position on the export side. A basic characteristic of the country is that it is relatively goods-rich and capital-rich. It therefore strives for outlets for its goods and capital. It appears elementary to state that it is inconsistent to promote high exports while consciously restricting imports. Yet, many persons seem to delight in pointing an accusing finger at foreign countries which discriminate against United States goods, when all the while the foreign countries may be laboring under a shortage of dollars. This is just another way of saying that multilateralism abroad logically requires, as its counterpart, relatively free trade at home. (The foregoing is not intended to imply that foreign countries do not bear a responsibility in the matter; the point here is simply that problems concerning United States foreign trade do not originate exclusively abroad.)

United States export policy is further complicated by the presence of domestic surpluses, especially of agricultural commodities, which must be disposed of in some manner. Exportation represents one possible outlet. In exporting such surpluses, however, one problem may be solved only to create others. For example, exports of surplus agricultural commodities normally occur at prices below the domestic level (in view of the price-support program in agriculture which results in domestic prices being held above the world level). This situation requires both (1) the subsidization of exports and (2) the imposition of import quotas (to preclude competitive imports from undermining the domestic program). Again, exports of surplus commodities, if they are to be paid for, require foreigners to part with dollar exchange. If the United States does not at the same time increase its imports (or launch investments abroad), the payments difficulties of foreign countries are merely compounded. The

crux of the matter is that the United States has both a foreign-trade problem and a farm problem. If the farm problem is to be dealt with in part through the exportation of surpluses, the result may well be to magnify the foreign-trade problem. A decision has to be made as to which problem is to be given priority in treatment, or how policies relating to each are to be reconciled. And, significantly, the farm problem is perhaps more pressing than is the foreign-trade problem!

Finally, the United States is an exporter of capital. The country is interested, therefore, in a favorable investment climate abroad. Such investment, of course, enables exports to occur without a like volume of imports having to occur in payment in the immediate future. Earnings from such investments, and eventual repayments, however, require an import surplus; the only alternative is a growing volume of foreign investment (or, eventual repudiation).

Summarizing, some major factors which figure in the formulation of United States foreign-trade policy include (1) considerable domestic resistance to the lowering of import barriers, (2) an urge to export, which causes opposition to arise to foreign import and payments restrictions, and (3) a desire for a favorable investment climate abroad.

A CASE STUDY: THE CHARTER OF THE ITO

Each country seeks to promote its own national self-interest, whatever this may be interpreted to mean. But because the problems which confront countries differ, the policies which they come to favor and pursue also lack uniformity. In fact, the resultant policies frequently tend to be in direct conflict with one another.

The difficulties involved in reconciling national policies within a coordinated international system were demonstrated following World War II in the attempts made to reach international agreement upon a Charter for an International Trade Organization (ITO). The Charter of the proposed ITO, largely the product of efforts of the United States Executive Branch, had as its major objective the establishment of a framework within which world trade might proceed on a *multilateral* basis free of restrictions and controls, *except* in so far as these might be deemed necessary under special circumstances. To promote the achievement of this objective, the Charter which was drawn up, following a considerable period of international consultation and three international conferences (London in 1946, Geneva in 1947, and the so-called "Havana Conference" in the winter of 1947-48) during which attempts were made to reconcile conflicting interests and points of view, proposed (1) a "code of con-

duct" to govern national policies and practices in so far as the latter had a direct bearing upon international trade, and (2) an organization (the ITO) to interpret and activate the rules agreed upon. Specific topics covered by the Charter include (1) employment and economic activity, (2) economic development, (3) commercial policy (tariffs, import quotas, export subsidies, state trading, etc.), (4) restrictive business practices (cartel activity), and (5) international commodity agreements. Enforcement of the provisions was to occur through indirect means, major reliance being placed upon the weapons of consultation and publicity; in general, the spirit in which the Charter was conceived was that the ITO should *help* countries in their efforts to adhere to the principles to which they had subscribed rather than to *compel* them to do so. The important fact is that no country was expected to compromise its sovereignty in subscribing to the principles of the Charter.

Despite the elaborate groundwork which had been laid, and despite the great care taken to draw up a document which would safeguard the interests of the various countries, the Charter was never put into force. It was apparent at the outset that membership by the United States was essential if the ITO was to have meaning. Therefore, when Congress failed to take action, no other country took the initiative to approve, and the Charter remained merely a proposal.

The Charter, though never put into force, continues to be of considerable interest because, as stated earlier, the negotiations which led to its formulation illustrate the difficulties involved in reconciling the diverse and sometimes conflicting national interests and policies of various countries. A first difficulty which was demonstrated was the failure of all countries to participate in negotiations; the U.S.S.R., for example, did not participate. A second difficulty arose from the fact that those countries which did participate desired, and were able to insist upon, the inclusion of special provisions designed to take account of their special interests; but in each case inclusion of these provisions constituted deviations from the avowed overall objective of the Charter of restoring free, multilateral trade. Some of these conflicts of interest, and the manner in which the Charter attempted to handle them, may be briefly cited:

1. **Import Restrictions.** The Charter, in keeping with the overall objective of promoting free, multilateral trade, expressed the general principle that the governments of signatory countries were to negotiate MFN tariff reductions and were to eliminate or reduce tariff preferences. The principle expressed was essentially that espoused by the United States in its Trade Agreements Program, i.e., a reduction of tariff barriers through

negotiation of mutual concessions. Two important exceptions to the general principle, however, were provided for. First, provision was made for the use by countries of "escape clauses" in their tariff agreements. This provision, inserted largely at the insistence of the United States, provided that if, as a result of unforeseen developments, a particular trade concession should increase imports by an amount sufficient to "cause or threaten serious injury to domestic producers," the country granting the concession was privileged to "suspend . . . or modify the concession."[1] Second, provision was made for the use of tariffs in order to promote "infant" industries.[2] This provision was inserted largely at the insistence of the underdeveloped countries, which are vitally interested in promoting economic development and are not averse to encouraging the process through use of direct governmental means.

The Charter was opposed in principle, too, to the use of other forms of import restrictions (e.g., quotas, restrictive import licensing, etc.), but again it allowed for several notable exceptions. First, import restrictions were deemed permissible for a country when needed to "forestall the imminent threat of, or to stop, a serious decline in its monetary reserves," or to "achieve a reasonable rate of increase in its reserves."[3] This provision was inserted largely at the insistence of those countries of Western Europe, especially Great Britain and France, which were troubled by the problems encumbent upon balance-of-payments deficits. Second, quotas were deemed allowable when needed to support domestic price-support or price-control schemes in agriculture.[4] The inclusion of the latter exception was especially desired by the United States.

2. **Export Subsidies.** The Charter was opposed in principle to the use of export subsidies. A major exception was made, however, in the case of primary commodities.[5] This exception was made largely at the insistence of the United States, since this country sought to retain the right to sell surplus farm products abroad at prices below the domestic level.

An Evaluation of the ITO Proposals

In order to draw up a Charter for the proposed ITO, many viewpoints and conflicting interests, several of the more important of which we have cited, had to be taken into account. The problem which confronted the

[1] Art. 40 - 1a.
[2] Art. 13 - 7a.
[3] Art. 21 - 3a.
[4] Art. 20 - 2c.
[5] Art. 27 - 1.

framers of the Charter was not a new one; countries have always been reluctant to give up their "freedom" (meaning, in this instance, the right to pursue independent national economic policies). The result, however, was a document containing a number of idealistic principles qualified by many exceptions. This fact served to bring forth the criticism that the Charter, when subjected to critical examination, reduces to little more than a collection of exceptions. As stated by one writer, "The basic principles which the Charter was originally intended to express and to enforce are wrapped up and swaddled in thick layers of exceptions and saving clauses, through which it may be hard for them to penetrate."[6]

Another line of criticism has been that, completely apart from the numerous exceptions allowed, the basic approach in terms of which the Charter was framed was both wrong in principle and unacceptable in practice. This criticism centered about the manner in which the Charter treated the problem of balance-of-payments disequilibrium. Since this has been a major world problem during recent years, and since there has been no single dominant opinion as to how to proceed in restoring balance-of-payment equilibrium, the treatment accorded the problem by the Charter bears special examination here.

First, the Charter viewed balance-of-payments disequilibrium as a *temporary* situation. It was assumed that the balance of payments of a country is normally in equilibrium, and that occasional deficits can be dealt with by means of import restrictions imposed as a temporary expedient. This view, which has a long history of popularity in American academic and official thinking, has been seriously questioned abroad by numerous economists and public officials, especially in those countries of Western Europe (e.g., Great Britain and France) which have a long record of balance-of-payments disequilibria. These persons have been inclined to the view that "The restoration of basic equilibrium in the international balance of payments is no mere passing problem. . . . It is a long-term, large-scale task."[7] If disequilibrium is long-term, import restrictions and discriminatory trade arrangements cannot properly be thought of as temporary instruments; rather, there then appears to be a case for their retention on a permanent or semi-permanent basis.

Second, the Charter placed faith in the effectiveness of the *price mechanism* as a factor in promoting balance-of-payments equilibrium. It was assumed that direct controls (import restrictions) may be warranted in event of a temporary disequilibrium in a country's balance of

[6] Sir H. Henderson, "A Criticism of the Havana Charter," *American Economic Review*, June, 1949, p. 605.
[7] *Ibid.*, p. 608.

payments, but that in event of a persistent deficit the work of readjustment ought to be taken over as soon as possible by price-system correctives (i.e., through domestic deflation or through exchange depreciation). This approach, fairly popular in the United States (where thinking is heavily influenced by free-enterprise concepts, including a belief in the "infallibility" of the price system), has generally been viewed as "bad medicine" in the deficit countries of Western Europe. There a usual view has been that small adjustments may well occur through the forces of the price system, but that in a situation which calls for large-scale readjustment "it is necessary to supplement and sometimes to supersede these forces by more direct measures, consciously directed to the object which has to be attained."[8] For a country which must basically alter its pattern of consumption and production, "Any necessary reduction of imports will be less injurious to its standard of life, if it is *selective*, falling heavily on some items and sparing others, than if it is indiscriminate."[9] In other words, a country's economy may be out of adjustment to such an extent, and relatively rapid readjustment may be so painful, especially if effected through the price mechanism, that the country has no practical alternative but to strive for balance-of-payments equilibrium through continuing indefinitely import restrictions and discriminatory trade practices. Balance-of-payments equilibrium is then promoted, not through the practice of free, multilateral trade as envisaged by the Charter, but through the continuance of trade restrictions and discrimination.

Third, the Charter viewed readjustment as the primary *responsibility* of any country having a deficit in its balance of payments, and largely absolved from responsibility any country having a surplus. The foregoing, of course, has been a reasonably popular notion in the United States, a country which has no balance-of-payments deficits, but it has not been well received in, say, Great Britain, which has had deficits during a number of years. In the deficit countries, a common view has long been that the responsibility for international adjustment should not fall primarily upon the deficit country, but should fall more particularly upon such countries as have surpluses in their balances of payments (meaning, for all practical purposes, the United States) and which, hence, are more able to endure such adjustments. As stated by one writer, countries should "reduce their tariffs and encourage imports, not in proportion to the reciprocal concessions they are able to secure, but in proportion to the strength of their balance-of-payments position."[10]

[8] *Ibid.*, p. 613.
[9] *Ibid.*, p. 615.
[10] *Ibid.*, p. 612.

Conclusion

In short, the attempt to formulate a Charter for the proposed ITO revealed two major sources of conflict in the international-trade field: (1) there is no uniformity of opinion among countries concerning the *specific policies* likely to prove advantageous to them, and (2) there is no uniformity of opinion concerning the *overall principles* which should govern the conduct of international trade. For example, as illustrated by the reactions evoked by the Charter, disagreement as to whether import restrictions should, or should not, be allowed as deviations from the overall principle of free, multilateral trade admittedly constitutes a problem in promoting international agreement, but it constitutes a relatively small problem as compared to the one which arises when it is discovered that not everyone shares the view that the principle of free, multilateral trade is in itself a worthy goal. In the absence of agreement on *overall* principles, there appears to be little hope for wide agreement on *specific* policies!

SUMMARY

Countries tend to adopt and pursue foreign-trade policies which they believe to be consistent, in each case, with the furtherance of their own national self-interest. In consequence, there exists in the world a series of uncoordinated national policies, some of which are in basic conflict with one another. Since individual governments are generally reluctant to compromise their own policy decisions, international agreement on matters of basic policy and practice is difficult to secure. This situation was demonstrated in clear-cut fashion following World War II in the attempt made to secure acceptance of the Charter for the proposed ITO.

SELECTED REFERENCES

*Henderson, Sir H., "A Criticism of the Havana Charter," *American Economic Review*, June, 1949.

U. S. Department of State, *Havana Charter for an International Trade Organization*, Publication 3117, Commercial Policy Series 113, Washington, 1948.

*Wilcox, C., *A Charter for World Trade*. New York: The Macmillan Company, 1949.

24

What Policy?

IN THE ABSENCE of *international* agreement, individual countries are obliged to assume sole responsibility for the choice of their own *national* foreign-trade policies. The national policy which an individual country will choose to pursue depends, of course, on the country's own interpretation of what is best for it in the light of its capacities, limitations, and aspirations, as well as upon what other countries choose to do.

Under these conditions, what overall policy should the United States pursue in its foreign-trade relations? Since the United States is the leading economic power in the world today, the answer given to the foregoing question is of vital importance, both for this country and for the rest of the world. In this chapter, therefore, an attempt is made to indicate the alternatives open to this country.

TWO POSSIBLE GOALS

From an overall standpoint, the United States might set for itself either of two basic goals.[1] The first of these involves the elimination of the

[1] Theoretically, a third goal might be set. This goal would involve the deliberate promotion of economic isolationism, i.e., a movement toward virtual national self-sufficiency. This possible goal is not seriously considered here, since the likely cost involved would be such that, as a matter of practical public policy, it cannot be regarded as a plausible alternative.

world dollar shortage, i.e., it envisages a simple restoration of balance-of-payments equilibrium at some undesignated level of trade. The second, and more ambitious, goal involves an attempt to promote balance-of-payments equilibrium, *but* to deliberately promote such equilibrium at a relatively high volume of trade in order thereby to secure for the country the "maximum" benefits to be gained from trade. The first goal centers on *equilibrium*, while the second emphasizes the *gains from trade*. (In a world in which free trade and the conditions of perfect competition prevail, the two goals cited become one and the same; balance-of-payments equilibrium and the maximization of the gains from trade occur at the same point. Neither free trade nor perfect competition is basically characteristic of the real world, however, so that the two goals represent quite different things from a practical standpoint.)

Elimination of the Dollar Shortage

During the years 1946-53, the world's dollar deficit totaled $32.1 billion (Table 23, Chapter 14); this amount, in other words, was the balance-of-payments deficit of the rest of the world vis-à-vis the United States. The deficit was offset almost dollar-for-dollar with foreign aid granted by the United States. In the opinion of some persons, the efforts of the United States should be directed toward preventing such dollar deficits in the future, thereby eliminating the need for this country to grant further foreign aid.

The view that the foreign-trade policy of the United States should be directed to the elimination of the dollar shortage figured prominently in the Report of the Commission on Foreign Economic Policy (the so-called "Randall Report"[2]), issued in early 1954. This Commission, established under terms of the Trade Agreements Extension Act of 1953, undertook to survey the existing foreign economic policy of this country and to make recommendations for future action. The report submitted by the Commission began with a statement of what it regarded as the central problem, the dollar shortage (arising out of balance-of-payments disequilibrium), and then proposed a foreign-trade policy for this country which, it was hoped, would aid in the elimination of the need for further United States foreign aid. Among specific proposals offered were (1) a further lowering

[2] Commission on Foreign Economic Policy, *Report to the President and the Congress*, Washington, January 23, 1954. The report is commonly referred to as the "Randall Report," named after the chairman of the Commission, Clarence B. Randall. The report was generally regarded as being highly controversial. About one-third of its text was given over to individual and group dissents, and a separate *Minority Report* was subsequently filed (January 30, 1954).

of United States tariff barriers, and (2) the adoption of measures designed to increase private United States foreign lending.

The view that the foreign-trade policy of the United States should be formulated with the express purpose in mind of eliminating the dollar shortage has been challenged on three major scores:

First, there is reason to doubt that elimination of the "dollar shortage" will also positively solve the world's "dollar problem" (although achievement of the former will admittedly assist in the achievement of the latter). The shortage of dollars — $32.1 billion during 1946-53 — was a statistical dollar shortage; it represented only the recorded deficiency in the world's earnings of dollars. Throughout this period, however, many foreign countries had in effect restrictions upon transactions requiring payments in dollars (Table 18, Chapter 8). In the absence of such import and payments restrictions in foreign countries, the dollar shortage would certainly have been greater than it was, but just how much greater no one can positively state. Therefore, even if the statistical dollar shortage were by some means eliminated, the dollar problem would not necessarily also disappear. A suppressed dollar shortage might still remain. In other words, the foregoing simply represents an application of the general principle (discussed in Chapters 5 and 9) that statistical balance can be made to exist in a balance of payments, but that the volume of trade then prevailing *may* be relatively low — precisely because of the existence of trade impediments imposed for the deliberate purpose of "forcing" balance in international accounts.

Second, the world's dollar shortage during 1946-53 was concealed to some extent by the existence of "extraordinary" transactions. The statistical dollar shortage which was recorded occurred over and above "unusual" transactions undertaken by the United States, virtually all of which had their origin in this country's defense effort. These transactions included purchases abroad in connection with stockpiling and the off-shore-procurement program. In 1953, for example, United States expenditures abroad on such defense-type items totaled approximately $2.5 billion, and for the entire period 1946-53 they totaled approximately $8.7 billion (Table 16, Chapter 3). To the extent that transactions of the foregoing type figure in this country's foreign-trade relationships, attempts to promote balance-of-payments equilibrium rest upon a relatively precarious basis. Even though in the future the dollar shortage ceases to exist in a statistical sense, the balance-of-payments equilibrium which then prevails may prove ephemeral by virtue of the transitory character of the defense-type transactions. The question always remains as to what will be the status of the dollar problem if this country for some reason decides to

slow down, or stop, its large-scale defense program. Clearly, if the achievement of balance-of-payments equilibrium is a goal, some thought needs to be given the matter of how the equilibrium is achieved, i.e., to the type (or "durability") of transactions.

Third, and perhaps most important, an approach to foreign trade which talks in terms of balance-of-payments equilibrium (i.e., the elimination of dollar deficits in this instance) without also talking about the volume of trade at which such equilibrium is to occur is less than complete. It is possible for equilibrium to occur in a balance of payments when the volume of trade is relatively low, when it is relatively high, or when it is anywhere in between. Equilibrium is simply a condition which prevails whenever total autonomous credits are equal to total autonomous debits in the balance of payments (Chapter 3). In the final analysis, if balance-of-payments equilibrium is the sole consideration, this goal may be achieved by a country through the simple expedient of terminating all its foreign-trade relationships. Balance-of-payments equilibrium then occurs at zero volume of trade! This example may appear far-fetched, but it serves to illustrate that balance-of-payments equilibrium *alone* is not enough. While we may desire balance-of-payments equilibrium, we prefer that it occur at a relatively high volume of trade rather than at a relatively low volume. The reason for this preference is not that a high volume of trade is desirable in and of itself; the preference is based on the fact that a relatively large volume of trade allows wider scope for the practice of international specialization and tends, therefore, to give the various trading countries more of the benefits to be had from specialization and trade. The latter notion leads to the second possible goal in the foreign-trade field: maximizing the gains from trade.

Maximizing the Gains from Trade

This second, and more ambitious, goal — the maximization of the gains from trade — combines the desire for self-sustaining balance-of-payments equilibrium with the desire for a relatively high volume of trade. The central idea is that foreign trade is justified on the basis of the benefits (i.e., more goods or more leisure) it yields to the peoples of the countries concerned. Such benefits arise because foreign trade (itself, in reality, the product of international specialization) makes possible the utilization of the world's resources and manpower in more economic fashion than possible in the absence of trade. If a little foreign trade is beneficial for a country, a larger volume may be even more beneficial (although presumably only up to a point). For reasons of national self-interest, therefore, it appears logical for a country to desire a relatively

large volume of trade in order to secure for itself the benefits which arise from international specialization. The ultimate goal, barring other considerations, is the "maximization" of these benefits. In maximizing the gains from trade, however, balance-of-payments equilibrium is not disregarded as a goal; rather, achievement of balance-of-payments equilibirum is merged with the aim of maximizing the gains from trade.

Thus, according to this line of reasoning, the ultimate goal, *barring other considerations,* should be the maximization of the benefits to be gotten from trade. Theory ("classical" theory) tells us that attainment of this goal calls for the practice of free (unrestricted) trade. But absolute free trade may not represent a practical policy for a country to pursue on a day-to-day basis. There *are* a number of other considerations which a country may, and generally does, find it necessary to take into account, and some, if not all, of these serve to rule out the practice of free trade. Three basic considerations which tend to preclude an all-out devotion to free trade on the part of the United States may be briefly cited:

First, domestic groups, typically expressing concern for the overall welfare of the country but frequently motivated by nothing other than narrow self-interest, on occasion bring pressure to bear upon the government for legislation which, if adopted, operates in opposition to the principle of free trade. It is a characteristic of a democracy, however, that the people can get what they want. If the pressure upon government from certain quarters is strong enough (and if the opposing pressures are not strong enough), action in some form is generally not long delayed.

Second, free traders in a sense hold that the operation of free-market forces lends direction in allocating resources and manpower in a manner superior to what is possible when government intervenes. Yet, it is generally acknowledged that the price mechanism does not operate either perfectly or in smooth fashion. The latter fact provides the rationale for government to lend the price mechanism a "helping hand," either on occasion or on a permanent basis. Whether government intervention produces a situation which is preferable is a moot question; the fact remains, however, that once such intervention occurs, the ideal environment for free trade ceases to exist. For example, the United States some years ago decided that free-market conditions in agriculture did not yield "desirable" results. Therefore, a system of government-administered prices in the form of the price-support program was instituted. Since under the program domestic prices were maintained above world prices, and since there existed a regular exportable surplus of major agricultural commodities, the government found it necessary to (1) subsidize exports, and (2) prevent, by means of import quotas, the influx of competitive

imports which might serve to undermine the domestic program. In short, interference with free-market forces at home led to the abandonment of free-market trading conditions with the rest of the world. As frequently stated by economists, regulations in the domestic economy tend to require a counterpart in the foreign-trade field.

Third, maximization of the gains from trade, taken by itself, may constitute a laudable goal, but it is by no means the only legitimate goal a country may have. A country ordinarily has *multiple* goals. For example, the United States *may* set for itself any number of possible goals, including the following: (1) the redistribution of national income (e.g., through the granting of special assistance to farmers, even if such should hurt some other groups in the economy), (2) the promotion of full employment (e.g., through the perpetuation of an export surplus, or through other means), and (3) the promotion of military preparedness (e.g., through the protection of defense industries, or the granting of aid to allies). According to some standards which we might devise, any one of the foregoing, or similar, goals might be made to appear just as laudable as the maximization of the gains from trade. Moreover, it is well to recall that there are goals which are completely non-economic in nature; there is no particular reason why every goal a country sets for itself needs to be viewed in terms of its economic justification alone. This is the crux of the matter which free traders frequently lose sight of. A government has many responsibilities, and in carrying out its functions it may deem it wise to forego some of the potential gains from foreign trade in order to promote gains in some other connection.

CONCLUSION

It is desirable that the notions which comprise the starting point in the formation of foreign-trade policy be "economically defensible." The economist can attempt to determine what foreign-trade policy, when taken by itself, is likely to prove most advantageous for a country (given certain criteria for measuring "advantage"). But, between this point and the emergence of actual public policy lies much territory. The process of government is a complex thing; between the multiplicity of goals, economic and non-economic, which a government may legitimately set for itself and the myriad pressures it is ordinarily subject to, the public policy which finally emerges is generally in the nature of a compromise of some sort.

Index

Index

Note: q. = quoted; n. = footnote